OUTLINES OF ECONOMICS

PART II

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CONTEN'

Book IV.

CHAPTER

Money

CHAPTER II

Credit and Banking

CHAPTER III

International Trade and Foreign Exchanges

BOOK V

CHAPTER I

Distribution

CHAPTER II

Rent

CHAPTER III

Wages

CHAPTER IV.

Labour Problems

CHAPTER V

Interest

CHAPTER VI

Profits

BOOK VI

The State and Economic Life.

CHAPTER I

Public finance

CHAPTER II.

Economic Functions of Governments Socialism (Economic Progress)

OUTLINES OF ECONOMICS

PART II.

MONEY

Importance of the Monetary System

There is a close connection between the system of exchange in a country and its economic development. The monetary system is adapted to the stage of industrial life reached by the people, and the higher the stage of industrial life the more developed is its system of money and exchange. Economic progress is in great part the cause and in some measure, at least the effect of monetary progress. This, however, has been sometimes overlooked; impulsive visionaries indignant at the evils springing from the immoral and wasteful use of wealth have wanted to do away with money altogether, and occasionally even economists of reputation have considerably under-estimated the importance of money in relation to the economic and social life of a community.

The intimate connection between the monetary system and economic progress

History of Money

In the early stages of human history, there was no money to serve as a common medium of exchange, and so exchange was done by *barter* (i.e. by the direct exchange of commodity for commodity without the use of money). The inconveniences of barter led to the use of money (i.e. a common medium of exchange.)

Exchange by barter at the first stage

The three serious difficulties in connection with barter are the following —

* Difficulties of barter

(1) The first difficulty is the want of coincidence in barter—it is difficult to find two persons whose disposable possessions mutually suit each other's wants. If I want to get a hat by barter in exchange for a superfluous coat of mine, I shall have to spend a great deal of time in trying to find a man who wants a coat and at the same time has a superfluous hat which he will barter for my coat.

(1) Want of coincidence in barter

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* Jevons—Money and the Mechanism of Exchange Chapter I

(The precious metal are expensive So we have paper money There is a large circulation of paper money in addition to metallic money within every civilized and progressive country, paper money economising the use of the precious metals in the country)

Characteristics of good commodity money

It has been seen that a great many commodities have been used at one time or another as money A commodity should possess certain qualities in order to perform its functions as money to the best advantage

(1) The commodity should have *value* in order that it may be a good medium of exchange and may measure and store value

(2) The commodity should have a *steady value* It must have this quality if it is to perform properly the functions of storing value and acting as a standard of deferred payments

(3) It should be *easily divisible* and *homogeneous*, and should be suitable for making payments in all sums large or small Again it should be aggregatable *i e* portions of it must be capable of being put together into a single mass without loss of value

(4) The commodity to be used as money should be also durable, it should have *indefinite durability* The metals gold and silver possess this element of durability in a greater degree than other metals like iron etc, and much better than agricultural products and so they are more suitable for use as money

(5) It should be also *cognisable* *i e* it should be capable of being quickly and easily recognised Otherwise people using it as money would be constantly running the risk of being cheated by fraudulent substitute

Gold and silver are very easily recognised by their colour, their sound and their weight

(6) It should be also *malleable* *i e* it should be suitable for coining and imprinting

(7) It should have *large value in small bulk*, if it be too bulky it would be inconvenient for use as money Of course the *commodity to be used as money must be selected according to the needs and the economical development of the country* Copper is a convenient medium of exchange in China with its smaller scale of payments, but in the United States with its larger scale of incomes, copper would be bulky and inconvenient and gold is required as a medium of exchange

Jevons* enumerates the following qualities in the order of their importance as qualities which should be possessed by the material of money—(1) utility and value (2) portability (3) indestructibility (4) homogeneity (5) divisibility (6) stability of value (7) cognisability

It is obvious that the precious metals gold and silver combine in a larger degree than any other substance the qualities required to make a good commodity money Gold and silver are homogeneous divisible, cognisable and malleable, they are very durable, they have great value in small bulk and a value steadier than that of most commodities Prof Jevons* has remarked in this connection, "*Of gold and silver, we may say with Turgot that by the nature of things they are constituted universal money independently of all convention or law*"

Functions of money

The functions of money have been variously classified They are divided by Prof Kinley, a notable American writer on money questions into the three following classes

(1) Essential functions or those which are necessary in all economic stages

(2) Derived functions or those which flow from or are dependent on the essential services

(3) Contingent functions or those which flow from the characteristics of a particular economic stage

(1) Essential functions

(*a*) *The facilitation of exchange by money serving as a medium of exchange*

Money serving as the medium of exchange removes the inconveniences of barter and thus facilitates exchange

This is a service which is rendered by money in all economic stages

(*b*) *The measurement of value*

The function of measuring value is inseparable from the first function, and this is also performed by money in all economic stages When we say that money is a measure of value, we mean the amount

* Jevons—Money and the Mechanism of Exchange

of value in a unit of money may be taken as a unit of measure for calculating the value of goods, *we reckon the values of goods in terms of money*

(2) Derived functions of money

The derived functions of money are

(a) *To serve as a standard of deferred payments*

Under the modern credit system, a considerable time often passes between the contracting of a debt and the payment of the debt In these and other deferred payments, it is thought desirable that the borrower should return to the lender the same value which he borrowed Money serves as a standard for these deferred payments

(b) *To transfer value*

Money transfers value from time to time as well as from place to place It serves both for the place transfer and the time transfer of purchasing power

(c) *To store value*

Money serves also as a store of value When we want to store value it is more convenient to hoard money than any other commodity The demand for other things may fall away, but money is always in demand (Money serves for the place transfer and the time transfer of purchasing power because it is a storer of value)

(3) Contingent functions of money

These are the following in the present state of economic society

(a) The distribution of social income (b) The equalisation of marginal utility in expenditures (c) The furnishing of the basis of a credit system, (d) Giving a general form to capital

[A brief account of the contingent functions is given below]

(a) Under the present system of division of labour and exchange, few men produce what they consume They are paid for what they produce in money, and with this money they buy what they want to consume Money in this way serves to distribute the wealth that is produced among the factors engaged in the work of production

(b) Money enables each individual to spend his income in such a way that each unit of money spent shall bring him goods of the same marginal utility—thus the individual gets the largest value for the money spent by him

(c) Another important service rendered by money is that it serves as the basis of the gigantic structure of modern credit The modern credit system is based

upon a reserve of metallic money, and this cash reserve is used to guar payment of the balances of credit transactions Credit paper (for exampl cheques,) will not be accepted in payment but for the fact that there is a cas reserve to secure the payment of the cheque in metallic money when sc required

(d) Money is the embodiment of generic value, it is general capital, and owing to its high mobility it is ready for the use whenever any new opportunity offers and thus extends production and exercises an influence to keep it at a maximum]

DEFINITIONS OF MONEY

Difficulties in defining money

To define money is difficult because the word money in ordinary language as well as in Economics is used to indicate any one of a number of things A good deal of controversy has taken place as to the proper definition of the term "money" , and this controversy has been largely due to the fact that different writers have referred to different things by the same word money The difficulties of definition disappear as soon as we decide in what sense the word money is properly used

A writer's definition of money depends upon the view held by him as to the nature of money, and to the services rendered by it Some of the different views held as to the meaning of the word money are given below

The word money used in a narrow sense

(1) Money is sometimes used to mean ony *commodity money* According to this view only metallic money is money because it has a value based on its direct use for consumption it has an intrinsic value due to a demand for it for other than monetary purposes Paper money is not money because paper has very little intrinsic value

This view is not correct Common usage is against using the word money to mean only metallic money and not paper money Paper money is also money, it has value if there is a demand for it as money

The word money is used in another narrow sense.

(2) The word money is sometimes used also to mean money instruments (metallic money and paper money, issued by the government, (bank notes and other things being thus excluded from the category of money)

This meaning of the word money is also too narrow and is against common usage and the general practice of economic writers

(3) Money is also used to describe (*a*) money made of gold and silver and paper money (*e g* banknotes and notes issued by the government) which are generally acceptable as money and (*b*) also bills of exchange and cheques which are not generally acceptable

Money ' used in a too wide sense

(4) The term money should be properly applied to *all media of exchange which are generally acceptable*, which pass freely from hand to hand as media of exchange

The proper sense of money, the sense in which it is generally used

In India, money in this sense would include (*a*) metallic money, gold and silver, (*b*) and the paper money or notes issued by the government. In the United States, money includes the metallic and paper money issued by the Government and the national bank notes Metallic money, notes issued by a Government or by a solidly established bank are instruments of general acceptability, they are readily accepted by all persons in payment from all persons, known parties as well as strangers so they are money

(Cheques and bills of exchange are not money in this sense because they are not instruments of general acceptability They are not accepted by us in payment from persons in whom we have no confidence)

Some definitions of money

(1) † *Ely's definition*

Money is anything that passes freely from hand to hand, as a medium of exchange, and is generally received in final discharge of debts

(2) *Kinley's definition*

'We may limit the term money to that part of the medium of exchange which passes generally current in exchange and settlement of debts, without making the discharge of obligations contingent on the action of a third party or on the action of the payer by promising redemption if the money article does not pass"

Coinage

The manufacture of metallic money is called coinage Coins

† Elementary Principles by Ely and Wicker

are stamped and certified pieces of metal and the object of a good system of coinage is to secure uniformity in coins of the same kind convenience of shape size and weight and to prevent counterfeiting

In all advanced modern countries, coinage is a function exercised by the government, an authority in which every one has confidence

The charge for coinage

A country is said to have a system of *free coinage* of a metal when every private citizen having bullion is allowed to bring it to the mint and to have it converted into coin

On the other hand a country is said to have *limited coinage* when coinage is done only on government account, and when the private citizen is not allowed to bring bullion into the mint and to have it converted into coins There is no free coinage of the rupee in India, it is subject to limited coinage The sovereign in England is subject to free coinage

A system of free coinage does not necessarily imply in all cases that no charge is made by the government for coinage Under the system of free coinage we may have

(a) *Gratuitous coinage* when no fee is charged by the government for the work of coinage

(b) Coinage on payment of *brassage*

The fee charged by the government for coinage is called brassage when it is exactly equal to the cost of ~~coinage~~ minting

If a fee larger than the cost of coinage is charged by the government the fee is called *seigniorage* (The expression seigniorage is also some times used to include brassage)

The rate at which gold coin is given by the mint in exchange for gold bullion is called the *mint-price of gold* In England, the mint price of standard gold is £3 17s 10½d per ounce i e each ounce of gold is manufactured into sovereigns at this rate

The currency

The medium of exchange in a country includes (a) *the medium of general circulation* or the currency including (1) metallic money (2) inconvertible paper money (3) certificates of deposit (4) convertible note

(b) *The medium of restricted circulation* including credit paper which does not circulate generally e g cheques and drafts representing bank deposits and bills of exchange representing goods

Standard Money, Token Money, Credit Money

The currency of a country includes Standard Money, Token Money and Credit Money

Standard Money is that money to the value of which the values of all other kinds of money are adjusted The standard coin is one of which the value in exchange depends on the value of the metal contained in the standard coin

Token money is money which is used as small change generally in transactions of comparatively small value Token money is generally made of a baser metal than the standard money, and *the value of a token coin is higher by law than the value of the metal contained in the token coin*

In England the shilling is a token coin As a coin, the shilling is worth $\frac{1}{20}$ of a pound, (20 shillings = £1) but the value of the silver contained in the shilling is worth much less than $\frac{1}{20}$ of a pound The penny is also a token coin

In India (before the war) the rupee is worth more as coin than what it is worth as metal when it is melted And so the rupee is also a token coin, other token coins in India are the two anna bit, the four anna bit, the nickel anna and the pice

Credit money or paper money is issued on the credit of the government or on the credit of a bank, and it is readily accepted by the people if the people have confidence in the credit of the institution issuing the money

One important thing to remember is that other forms of money (token money, credit money) are exchangeable directly or indirectly into standard money

The currency of a country includes *Legal Tender Money* and money that is not legal tender Legal tender money is money which a creditor is obliged by law to receive in repayment of a debt due to him

Generally the standard money is made unlimited legal tender *i e* it is made legal tender up to an unlimited amount The sovereign is unlimited legal tender in England Token money is generally made limited legal tender *i e* legal tender up to a limited amount In England the shilling, a token coin is legal tender only up to forty shillings In India the rupee though a token coin is unlimited legal tender

The standard money is (a) *subject to free coinage* (b) being subject to free coinage has its nominal value or *coin value equal to its intrinsic value as metal* (c) and is *unlimited legal tender*

Token money is (a) *not subject to free coinage* but is subject to limited coinage at the discretion of the government (b) and it has a face value or *coin value greater than its intrinsic value as metal* (c) and is very generally *limited legal tender*

GRESHAM'S LAW

(A law about the circulation of money)

This law is named after Sir Thomas Gresham, one of the financial advisers of Queen Elizabeth who called attention to the operation of this law in the currency of his own time

The law is this—*bad money drives good money out of the circulation* When two kinds of money (one bad and the other good) are in circulation in a country at the same time, the bad money will remain in the circulation and the good money will be driven out of the circulation

We have to explain (1) why bad money remains in circulation and (2) why good money retires from the circulation

Bad money will remain in circulation because most men will make their payments with bad money keeping the good money for themselves, *so long as bad money is not refused*

Good money will disappear from circulation because it will have higher value out of the circulation than in the circulation, and so people will gain by taking good money from the circulation and by using it for industrial and other purposes (viz melting, hoarding and also payments abroad) where good money has a value higher than it has in the currency circulation

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† The law was in fact known much earlier than Gresham's time, and it seemed to have been recognised even among the ancient Greeks

In the "Frogs" of Aristophanes, a great Greek comic dramatist we find the following —

"For your old and standard pieces, valued and approved and tried,
Here among the Grecian nations and in all the world beside
Recognised in every realm for trusty stamp and pure assay,
Are rejected and abandoned for the trash of yesterday,
For a vile, adulterate issue, drossy, counterfeit and base
Which the traffic of the City passes current in their place"

I How does good money disappear?

The good money will be driven from circulation in the three following ways

(a) *Hoarding*

When people want to hoard money for future emergencies, they will naturally hoard the good money and not the bad money A portion of the good money may be thus driven out of circulation

(b) *Payments abroad*

A country has sometimes to remit coins to make foreign payments rising out of international trade and other international transactions

Now for these foreign payments, good money will be used in preference to bad money The reason is this Foreign creditors will take bad money as well as good money only at their value as metal, and so a smaller number of good coins would be required to make the same foreign payment for which a larger number of bad coins would be wanted The foreign creditors will therefore be paid in good coins Bad coins will be retained for the internal circulation of a country where they have the same value as good coins (so long they are legal tender and are accepted by people at their coin value)

(c) *Sale by weight.*

Suppose a rise in the value of gold makes the value of the coin as metal greater than its value as a coin The result is that people will make a profit by melting gold coins and selling the gold as metal In this way a considerable part of good money is often driven out of circulation

II The extent of application of Gresham's law

Gresham's law applies to the following cases

(a) When a *worn money* as well as *newly coined full weight money* are in circulation at the same time, the worn money is bad money, and the newly coined money is good money In the case the newly coined money will be driven out of circulation

The law was observed by Sir Thomas Gresham under these circumstances

(b) When a *depreciated paper money* is in circulation with a *metallic money*, the depreciated paper money is bad money and the

metallic money is good money The metallic money will be driven out of circulation by the depreciated paper money

(c) *When two metals gold and silver are in circulation and the value of one of them is higher in the currency than in the market for metals* Suppose one ounce of gold in the form of coin is equal to sixteen ounces of silver in coined form, but as metal one ounce of gold purchases only fifteen ounces of silver, then gold becomes bad (*i e* depreciated) money and silver becomes good (*i e* appreciated) money, and silver is driven out of circulation Silver is withdrawn from the circulation because it has a higher value as metal than the value it has in the circulation in its coined form (This third case often happens under bimetallism)

III **Gresham's law—its limitations** *

(1) *Good money as well as bad money will remain in the circulation, so long as the good and the bad money taken together are not in excess of the monetary needs of the community*

If the total stock of good money and bad money be insufficient for the needs of the community, then owing to the great demand for money even the good money will have a greater value in its coined form than as metal So it will not be profitable to withdraw good money from the circulation and it will remain in the currency circulation

(2) *Again bad money and not good money will be driven from the circulation, when bad money is refused by the public on account of custom or public opinion* If in a country, people, refuse to accept inconvertible paper (bad money) and want gold, inconvertible paper will be driven from the circulation

Gresham's Law in India

The operation of Gresham's Law is found in the Indian Currency The gold sovereign is *good money*, it has an intrinsic value equal to its metallic value, and as compared with the sovereign the silver rupee is *bad money*, it has a face value in normal times (*i e*, before the war) higher than its intrinsic value—

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* In view of these limitations Prof Kinley puts the law in this comprehensive form "If more than one form of money is legally usable in a country, and if one of these is more valuable for some other use than it is for making exchanges, then the inferior portion of the currency will supplant the superior to the extent that the two portions together exceed the need for currency in the country provided that public opinion or any other economic force does not interfere with the operation of the self interest of dealers in money"

Gresham's law is really a limited statement of a more general principle In a community in which competition is free and intelligent, there is a constant effort to perform every economic service by the agency which yields the largest net results

and the bad money has a tendency to drive out the good money The sovereign disappears (i) by exportation abroad when India has a balance of debt to pay to foreign countries, (ii) by melting for ornaments and industrial uses, (iii) and largely by hoarding The rupee is not exported because the foreigner will not take it at its artificial high value it is not melted for that would be a loss to the melter, and when an Indian hoards he prefers gold to silver, and the gold sovereign to the token rupee with its artificial high value

Systems of metallic currency.

There are different systems of metallic currency

A monetary system in which the principal or standard money is composed of one metal (gold or silver) is called monometallism

Monometallism

In England the standard money is composed of gold, and so England has got gold monometallism China has got silver mono-metallism

A monetary system in which the principal or standard money is composed of gold and also of silver is called bi-metallism It is essential to a complete bi-metallic system that

Bimetallism

(*a*) *both metals* should be *unlimited legal tender* and (*b*) both should be *freely coined at a fixed ratio of exchange* between the two metals In all modern countries where bi-metallism has been tried the two metals used have been gold and silver

Under mono-metallism, only one metal forms the standard money and is the standard of value, only one metal is unlimited legal tender and only one metal is freely coined and is important in the circulation

Under bi-metallism, two metals form the standard money and are the standards of value and two metals are freely coined and are unlimited legal tender and are important in the circulation

Limping Bi-Metallism

A monetary system in which two metals are unlimited legal tender and are important in the circulation, but only one has got free coinage—such a monetary system is called Limping Bi-metallism or imperfect Bi metallism France has got gold and silver coins as unlimited legal tender but only gold coins have got free coinage France has therefore got the Limping Standard

Decline of bimetallism

Bimetallism was tried in the United States many years ago It was also practised in France and then in the countries of the Latin Monetary Union from the end of the eighteenth century till 1873

The Latin Monetary Union included France, Italy, Greece, Belgium and Switzerland

Triumph of gold monometallism

For some time the tendency of monetary evolution has been in the direction of gold monometallism and bimetallism is being displaced The system of gold monometallism has been established in England 1816, Germany 1873 Austria 1892, Russia 1897, Japan 1897 France and the United States are bimetallic countries having a system of limping bimetallism, but they also use gold alone for international exchanges, and this is also practically the case with India

The displacement of silver is an important chapter of monetary history For hundreds of years silver had been freely coined and had been the more important money metal of the world, and it was deposed and discarded from this pride of place in the brief course of one generation

I BIMETALLISM
(The Double Standard)

The arguments usually urged in favour of bimetallism

Bimetallism is no longer an active force The agitation for bimetallism is now a thing of the past though in its time it was very urgent, insistent and widespread in character and powerfully supported by a strong body of scientific opinion

The arguments of these advocates of bimetallism are noticed below

The main requisite in a standard of value is that its value should be as far as possible stable (*i e*, its purchasing power) should be constant Advocates of bimetallism maintain that *bimetallism secures a more stable standard of value and more stable prices than monometallism* in the following ways (*a*) They say that when two metals are used the total stock of money is larger than only when one metal is used to form standard money, and

† Bimetallism provides a more stable standard of value than monometallism and lessens fluctuations of prices

† Bimetallism is the only scheme for securing stability of the standard of value which has received any substantial measure of popular support Other schemes with this object are at present only of academic interest—

the total stock of money in bimetallism being larger, any addition, to the quantity of money will affect the value of money and the price level in a smaller degree than under mono-metallism (*b*) † It is also urged by the bimetallists that the increase or decrease in production of one metal will be often counteracted by the decrease or increase in the production of another metal, and so the total result will be that the value of money will be steadier under bimetallism than under a mono-metallic system, and therefore general prices will be also steadier under bimetallism This argument has a certain amount of value

Historically, bimetallism in France in the period immediately after 1850 served to steady (i) the ratio between gold and silver (ii) and the general level of prices So far the bimetallists were justified But since 1890, there had been a great increase in the supply of gold from the world's mines and the indications are that there would have been also a great increase in the supply of silver if bimetallism had been established with the free coinage of silver and so the establishment of bimetallism instead of steadying prices in fact would have made prices less stable than they are under monometallism]

(2) *Bimetallism by a rise in prices benefits producers and encourages production*

Some bimetallists maintain that under bimetallism the total money stock would be larger and would increase more rapidly than under mono-metallism, and thus there will be a gradual depreciation in the value of money and rise in prices under bimetallism which will stimulate producers by increasing profits

Owing to the demonetisation of silver in 1873, prices fell and the fall in prices discouraged producers

(3) *Bimetallism by a rise in prices (and a fall in the value of money) benefits debtors*

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polymetallism (circulation of more than two metals), symmetallism (two or more metals joined physically together in the same coin or in linked bars'), joint-metallism (a kind of bimetallism at a fixed ratio), also Fisher's scheme of the compensated dollar and an artificial gold-exchange standard (Fisher—The Purchasing Power of Money, Chapter XIII)

† The fact is that under certain exceptional conditions even one metal may secure more steadiness than two metals "*Two variable metals joined through bimetallism may be likened to two tipsy men locking arms* Together they walk somewhat more steadily than apart, although if one happens to be much more sober than the other, his own gait may be made worse by the union" (Fisher—The Purchasing Power of Money chap XIII)

According to some advocates of bimetallism, the bimetallic system brings about a gradual depreciation in the value of money and thus benefits the debtor class by reducing the burden of debt

The bimetallists also declare that the single standard (mono metallism) leads to a rise in the value of money and thus injures debtors by increasing the burden of their debt

(4) Under a complete system of bimetallism in which both metals are unlimited legal tender for all payments, the banks would be able to keep and manage their reserves of metal more easily and economically and the rates for money would be lower and more uniform

Bimetallism helps banks

(6) Another very important claim made by the bimetallists is that bimetallism helps the development of foreign trade by establishing a par of exchange between gold-using and silver-using countries

And stimulates foreign trade

Now two countries having the same metal as the standard of value, have *a par of exchange* between them in their international trade (exchange being said to be at par when a merchant paying a certain amount of money metal in his own country can purchase the right to get exactly the same amount of metal in the foreign country) But between two countries one having silver as the standard of value and the other having gold as the standard of value, there is no par of exchange, the relative value of gold and silver is not a fixed one but fluctuates according to the variations of demand or supply of the two metals

If several nations accept bimetallism and establish a fixed ratio between gold and silver by international agreement, a par of exchange between them is established There will be no fall in the price of gold as compared with silver, or fall in the price of silver as compared with gold, merchants will not suffer any losses in their foreign trade through fluctuations in the price of gold or silver, and the risks of business being thus diminished, the commerce between gold-using and silver-using countries will be increased

7 Some Arguments usually advanced against bimetallism

(1) * *Bimetallic countries have really one money and that the worse money*

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* Some noted historical examples of this are given below

(A) Currency History of France.

(1) In Europe, many countries adopted gold monometallism by the

If a nation accepts bimetallism, then under the operation of Gresham's law the country will be left with the bad money (bad money *i.e.* money overvalued in the circulation and having a higher value as coin than as uncoined metal) and the other metal will go out of circulation.

(2) Opponents of bimetallism declare that when the legal ratio between the two metals in the currency will differ from the market ratio *creditors will want payment in the dearer metal and debtors will want to pay in the depreciated metal*. A great deal of confusion will be the result of all these.

(3) (Prof. Marshall urges the following important considerations.) If the use of gold in the arts increases, the value of gold will rise, and if in the currency a fixed ratio between gold and silver is established, then the market ratio between gold and silver will differ from the monetary ratio. There will be *speculation* as a consequence of this, and its attendant evils.

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year 1873, and in the countries of the bimetallic league called the Latin Union silver being overvalued in the circulation, under the operation of Gresham's law gold began to disappear from these countries and flowed into the gold monometallic countries. The countries of the Latin Union were threatened with the danger of being left with one money (silver money) and that composed of the metal having a higher value as coin than as bullion.

Silver threatening to displace gold

(2) During the rule of the Third Napoleon in France the silver money being undervalued in comparison with gold in the currency, gold (bad money because overvalued in the currency) began to displace silver from the circulation.

Gold driving silver out of the circulation

(B) Currency History of the United States

The currency history of the United States also furnishes striking examples. (1) In 1792 the ratio between the gold and silver in the currency was made 1 to 15. When silver became cheaper than this in the market, silver money began to drive out gold from the currency.

Silver money left and gold driven out

(2) Later on in 1834 the Government established the ratio of exchange between gold and silver in the currency at 1 to 16 (1 oz of gold—16 oz of silver). The value of silver in the market as bullion rose higher than that, and silver, being thus undervalued and gold overvalued in the currency, gold drove silver out of circulation and the silver dollar disappeared from the currency.

Gold left and silver driven out

(3) The demonetisation of silver by Germany, Holland and other European countries and the stoppage of the unlimited coinage of silver in

Is bimetallism practicable?

In addition to the arguments already advanced in favour of bimetallism (see pages 14, 15, 16), the bimetallists maintain that the bimetallic system is quite practicable. They maintain that this is shown by the experience of the Latin Monetary Union which successfully maintained a bimetallic system from the end of the 18th century to 1873.

At the time of the establishment of bimetallism the legal ratio between the two metals in the currency should be the same as the market ratio between the two metals in the market for metals, and if this be done then the legal ratio can be maintained under certain circumstances.

If only one country accepts bimetallism then the ratio will not be maintained and bimetallism will collapse. As soon as the value of one of the metals rises or falls in the market owing to the fluctuations of demand and supply, the market ratio between the two metals comes to differ from the legal ratio and under the operation of Gresham's law the good money (*i.e.* the money made of the metal which has a higher value as metal than as coin) will be exported to foreign countries and the country will be left with *only one money* (bad money made of the depreciated metal.)

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the countries of the Latin Union diminished the demand for silver there was an increase in the supply of silver at the same time owing to the discovery of large silver mines in the United States. The result was a great decline in the value of silver as compared with the price of gold. *Two Acts were passed by the United States to stop the depreciation of silver, and to keep gold as well as silver in the currency.* The United States passed the *Bland Allison Act* (in 1878) authorising the coining of not less than two million and not more than four million dollars worth of silver per month and it passed the *Sherman Act* in 1890 authorising the purchase by the treasury of four and a half million ounces of silver a month.

The Sherman Act did not succeed in stopping the depreciation in the value of silver. There was a serious danger that the people of the United States would be left only with one money, viz. the money made of depreciated silver, and so the Sherman Act was repealed. (The United States Currency Act of 1900 expressly declares that the gold dollar shall be the standard of value and thus makes the United States practically a country of gold mono-metallism.)

The threatened disappearance of gold prevented by the establishment of gold mono-metallism.

But if many countries accept bimetallism with a fixed ratio between gold and silver, then the operation of Gresham's law can be counteracted and *bimetallism can be maintained at the legal ratio* fixed upon by the government

Suppose the governments of several nations establish bimetallism at the ratio of 15 to 1 (1 oz of gold in coins = 15 oz of silver in coins) that being also the market ratio at the time Then after a time the value of one of the metals *viz*, silver falls in the market—1 oz of gold bullion becomes equal to 16 oz of silver bullion The value of silver being now higher in the form of coins than as bullion, people will find it profitable to coin silver bullion into silver coins debtors will now want to make their payments by coining the depreciated metal (*i e* silver) and in this way there will be an increased demand for the depreciated metal and the increased demand for the metal will check the depreciation of its value. Payments will be made now in silver and not in gold and so there will be less demand for gold and the price of gold will fall *In this way by a rise in the price of the depreciated silver and by a fall in the price of gold, the ratio between gold and silver as bullion metal will tend to be brought back to the legal ratio* between gold and silver in the currency (1 oz gold in coins = 15 oz of silver in coins) This is called the *compensatory action of bimetallism*

Compensatory action of the double standard

The larger the number of countries accepting bimetallism at the same fixed ratio, and the greater the economic resources of these countries, the stronger will be this compensatory action

It thus appears that *national bimetallism* (bimetallism established in one country independently of other countries) is impracticable, *international bimetallism* (bimetallism established at a fixed ratio by the joint agreement of several nations) is practicable

Under what conditions is a bimetallic system practicable?

(1) The first condition is that it must be accepted at a fixed ratio by the joint agreement of several industrially and commercially powerful nations *With bimetallism universal or general among nations, the ratio might be maintained*

(2) An increase in demand for a money material of a higher monetary utility (gold) coinciding with an increase in the supply of the cheaper metal (silver) during a period of rapidly increasing wealth would work against the maintenance of the bimetallic ratio Prof Kinley remarks, "*During prolonged periods of slow*

(1) Gold mono-metallism is simpler than bimetallism and so more easily worked in practice

(2) Gold being the dearer metal is more serviceable as currency to the rich and economically progressive communities with their large scale of incomes and transactions

(3) Prof Kinley holds "The fluctuations in the value of gold under monometallism cause no greater difficulties *in the long run*, than would occur in prices under the bimetallic system"

(4) Again the progress of industrial invention gives us good grounds for believing that the supply of gold from the mines will be equal to the demand for gold under the system of mono metallism It is not likely that there will be any serious shortage of gold for monetary purposes if gold monometallism is established

III The Gold-exchange Standard

If in the monetary system of a country we have (1) coins of two metals as unlimited legal tender (2) the use of a local currency mainly not of gold in the internal circulation, and some degree of unwillingness to supply gold (international currency) for internal circulation in exchange for the local currency (3) a high degree of willingness to give international currency in exchange for local currency at a certain maximum rate for making payments to foreign countries, and the use of a reserve of the superior metal and other foreign credits for this purpose, then such a system is called *a Gold exchange Standard* India has got a gold-exchange standard—she uses an inferior metal (silver) for the local currency, and makes gold (international currency) available for foreign payments, at a certain maximum rate in exchange for local currency

The gold-exchange standard was first introduced into Java, and it is now in operation in India, the Philippines, Mexico and Panama

The Indian gold-exchange standard has an internal currency chiefly of rupees, and it makes gold available for foreign payments in exchange for rupees—and so it is called *a compromise standard*, a compromise between the silver and the gold standard It has been also described as *a gold standard without a gold currency* there being no considerable circulation of gold coins in India

Admirers of the Indian gold-exchange standard claim for it two great merits (i) cheapness—the internal currency is cheap, consisting of artificially appreciated rupees (ii) stability of exchange with

foreign countries and they even claim that the gold-exchange standard is the standard of the future in all countries

During the last great war, governments have issued vast quantities of paper money, and they have in various ways greatly economised the use of gold in the internal currency, and have accumulated large gold reserves It is maintained by some writers (i) that this greatly diminished use of gold in the internal currency during the war period, and the increased used of paper money have prepared the people for the introduction of gold-exchange standard and all its economies in almost all large modern states (ii) and that the economy of the gold-exchange standard is a very great advantage to governments and peoples when they are groaning under the burden of heavy taxation and enormous increases of national debts due to the war

England (with London as the centre of the world's money market) and the United States of America are not going to adopt the gold-exchange standard

(There has been a good deal of criticism of the gold-exchange standard, and one notable critic is Prof Nicholson †)

Paper money

Paper money has been used from very early times to replace a part of the metallic money for carrying on the exchange transactions of the community

The history of paper money in Europe begins much later than its history in Asia

In China it was used in the ninth century and possibly even earlier than that Japan and Persia introduced paper money perhaps in imitation of the Chinese And there is some reason for believing that it was in circulation even in ancient Assyria and Babylon

The enormous quantities of paper money issued by modern governments during the last great war make this subject one of great interest and importance at the present day

Three kinds of paper money

There are three kinds of paper money

(1) *Representative paper money* The person or the institution issuing a representative paper money keeps a *reserve of metal*

† Nicholson—Money and Monetary Problems, War Finance

exactly equal to the nominal value of the notes issued. Representative paper money represents an equivalent amount of metallic money deposited somewhere. This kind of paper money is as safe as metallic money because it represents an equal amount of metallic money, and it is at the same time more convenient and economical. Representative paper money may be issued by governments or by banks.

The gold and silver certificates of America are examples of representative paper money.

(2) *Convertible, redeemable or fiduciary paper money. This consists of notes for which specie can be had on demand.* It takes the form of a promise to pay a certain sum of metallic money.

As all the note holders do not desire to convert the notes into metal at the same time, so *the amount of metal* to be kept as a reserve for securing the convertibility of the notes is *generally much smaller than the face value of the notes issued.*

(3) *Inconvertible or irredeemable or conventional paper money.*

This consists of notes for which specie cannot be obtained on demand.

The pieces of paper money of this description contain a printed statement that the notes are of such and such value (a note for 100 francs, a note for 500 francs), but they are not intended to be paid in metallic money.

Inconvertible paper consisting of notes issued by a government without the intention of paying it in specie is also called *fiat money.*

There are two kinds of inconvertible paper money (1) paper which is inconvertible from the time of its issue (2) paper which was convertible when it was first issued, but which has ceased to be convertible on account of the subsequent insolvency of the issuers. "No paper money is convertible, the full, immediate and unconditional redemption of which is not at all times within the choice of the holder."

Some noted historical examples of irredeemable paper are the French *assignats* of the revolutionary period, the Bank of England

notes during the period of restriction and the *greenbacks* issued by the American Government during the Civil War.

Immense quantities of the paper money issued during the last world war are practically inconvertible and are attended with the evils of inconvertibility.

Whether the creation of paper money is equivalent to the creation of wealth?

I. Earlier view—John Law and others.

Paper money is wealth.

Formerly it used to be believed that the creation of paper money was equivalent to the creation of wealth. It was held that the total wealth of a country was increased by the amount of paper money that was created. The fallacy of this idea has now been clearly exposed and it is no longer believed in.

II. The modern view is different.

Paper money increases the wealth of a country to the extent it replaces metallic money.

Suppose a country has got ten millions of ounces of gold in the currency. If it can replace even five millions of ounces of gold by an equivalent amount of paper money, it can employ this gold to purchase commodities from abroad or for investment in agricultural or manufacturing industries at home. Paper money will thus liberate five millions ounces of gold for productive purposes and will make the country richer by five millions of ounces of gold.

Thus paper money increases the wealth of a country to the extent it allows the quantity of metallic money in the circulation to be replaced and no further.

Advantages of paper money

(I) If a country has got enough metallic money for all its wants, and if it then introduces a certain amount of paper money in circulation, the country will be benefited in the following way. Paper money will replace a part of the metallic money and this metallic money can be invested in domestic industries or used to purchase commodities abroad.*

The use of paper money saves Labour and Capital

If all countries gave up the use of metallic money, then the labour and capital which are now used for mining the precious metals for monetary purposes, this labour and this capital can then be used for other productive objects.

(II) When the precious metals are used as means of exchange, there is a great loss through the wear and tear of metals. There would be a large saving in this respect if paper is used as a means of making exchanges.

It saves loss through wear and tear of metals

(III) Paper money is more convenient than metallic money for making large payments, and also payments in distant places.

It is convenient

It can be sent to a distance at less cost than metallic money, and the risk of loss is smaller.

These three are the economic advantages of paper money.

(IV) The fiscal or financial advantage.

A government borrowing money has to pay interest on the loan. It may get money for its payments to its officers, contractors, etc., by issuing paper money, and in this way it would save the interest which it would otherwise have to pay.

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* "The gold and silver money which circulates in any country may be very properly compared to a highway which, while it circulates and carries to market all the grass and corn of the country, produces itself not a single pile of either. *The judicious operations of banking, by substituting paper money in the place of a great part of this gold and silver*, by providing, if I may be allowed so violent a metaphor, a sort of waggon-way through the air, enable the country to convert, as it were, a great part of its highways into good pastures and corn fields, and thereby *to increase very considerably the annual produce of its land and labour*." (Adam Smith—The Wealth of Nations)

This device of issuing paper money for fiscal purposes is often largely utilised in countries which have bad credit those countries which cannot get people to lend them money at all or which can borrow only at a high rate of interest

Disadvantages of paper money

(1) *Paper money is much less stable in value than metallic money.*

Want of stability in value

The quantity of paper money issued depends upon the caprice or the policy of a government and so it is often issued in excessive quantities and a great fall in its value is the result There is a natural check to the supply of metallic money in its high cost and so excessive additions to the stock of metallic money are not possible as is possible in the case of paper money, and therefore the value of metallic money fluctuates less than the value of paper

Uncertainty

(2) *The value of paper money is precarious* or uncertain because it depends wholly upon the will of a government A government gives by law a value to paper money and by another law the government can deprive paper money entirely of its value Metallic money, on the other hand will have a value depending upon the value of the metal even when the law ceases to recognise it as money

Limited area of circulation

(3) *Paper money is national money*, circulating within the territory under the same government It has no intrinsic value, so it will *not* be *accepted by foreign nations* in their payments Foreign nations will take metallic money which has intrinsic value metallic money is thus universal money

Prof Gide enumerates the above mentioned disadvantages of paper money and he suggests that these disadvantages would be greatly reduced if all civilised countries bind themselves by international agreement

(1) to give legal currency to one single paper money (*i e international paper money*)

(2) not to increase the quantity of it or to increase it only in a proportion fixed beforehand calculated for each country say in proportion to the increase of its population etc

Inconvertible paper (irredeemable paper) money

(I) Advantages

The *advantages* which inconvertible paper possesses in common with convertible paper are given on pages 25, 26

(II) Evils of irredeemable paper

Danger of over issue and depreciation

(1) Little or no reserve being required in a system of inconvertible paper, the danger of over-issue resulting in depreciation of value is greater in the case of inconvertible paper.

And of course its value is much less stable than the value of gold money.

Over issue of inconvertible paper drives out metallic money

(2) Under the operation of Gresham's Law over-issue of inconvertible paper drives metallic money out of the circulation, the displaced metallic money being hoarded, melted or exported to foreign countries.

(3) Inflated prices resulting from an over-issue of inconvertible paper *increase the risk of business*. Unhealthy speculation becomes a feature of business under these conditions.

(4) The *spirit of gambling* introduced into business affects injuriously the standard of business morality.

(5) The rise in the nominal price of property on account of inflated prices makes people think themselves richer than they actually are. And so they indulge in extravagant and wasteful expenditure.

Labourers suffer

(6) The wages paid in paper money do not rise as quickly and to the same extent as the prices of commodities, so labourers suffer seriously.

What is over-issue of inconvertible paper

Other things being equal, when paper money is issued and comes in circulation it will displace metallic money in the circulation. The larger the issue of inconvertible paper the greater will be the amount of metallic money displaced. *When the quantity of paper money issued exceeds the quantity of metallic money displaced, then we have an over-issue of inconvertible paper*, an issue in excess of demand.

Signs of excessive issue of inconvertible paper

The over-issue of paper money leads to great evils which have been already enumerated. And so statesmen and economists study

carefully the signs which indicate that there has been an overissue of inconvertible paper

(1) The first effect and the first sign of an overissue of inconvertible paper is *a premium on gold*. Inconvertible paper when issued in excess depreciates in value. Metallic money retains however its former value, and so it now commands a premium in terms of the paper money, (in other words the value of inconvertible paper falls—£1 in metallic money will be worth more than £1 in depreciated inconvertible paper). Persons who require gold to make payments abroad or for other purposes will pay this premium to obtain gold.

Premium on gold

(2) This premium on gold is shown also in a rise in the rate of exchange. The rate of exchange is the rate at which foreign bills of exchange are sold, and as these bills are payable in metallic money and generally in gold, a premium on gold will bring about a rise in the rate of exchange.

Rise in the rate of exchange

(3) Another sign is the disappearance of metallic money. When bad money in the shape of inconvertible paper and good money in the shape of the metallic money are in the circulation together, by the operation of Gresham's law metallic money disappears from the circulation.

Disappearance of metallic money

(4) The fourth sign is a rise in prices. This happens when there has been a very considerable overissue of inconvertible paper, and so the evil has become a serious one; this does not happen when the depreciation of paper money is small, say 2 or 3 per cent.

Rise in prices

The price level of the country under a paper money regime thus becomes different from the world price level.

4. The regulation of irredeemable paper to prevent over-issue and depreciation.

A considerable body of opinion is entirely against the issue of inconvertible paper by governments.

If inconvertible paper money is at all issued by a government, means should be taken for regulating the amount of inconvertible paper with a view to prevent depreciation and its attendant evils.

(*a*) Some have proposed to measure fluctuations in prices and

to increase or decrease the amount of inconvertible money in accordance with these fluctuations

This is not possible in practice and the theory underlying the proposal is not quite sound

(*b*) One practicable means to prevent over-issue of inconvertible paper money is to regulate the quantity of inconvertible paper so as to prevent the appearance of a premium on gold So long as there is no premium on gold, there is no over-issue of paper

When a Government notices a premium on gold, and a rise in the rate of exchange, it should know that there has been over issue of inconvertible paper Its duty now is to prohibit the issue of any more paper money, and if it finds the extremely dangerous sign of two different sets of prices (one payable in metallic money and the other payable in inconvertible paper) it should destroy the paper money that returns to its Treasury to reduce the amount of paper money in circulation

Inconvertible specie

As there is inconvertible paper money so there may be inconvertible specie The Indian rupee is an example of inconvertible specie It has been remarked of the *Indian rupee that it is 'an inconvertible note printed on silver*'—the rupee is no convertible into gold, the Indian government is not bound by law to give gold in exchange for rupees and other inconvertible notes are printed on paper while the inconvertible rupee is printed on silver

In normal times (i e before the war) the artificially high value of the rupee depends upon the limitation of quantity—and this limitation of quantity is made possible by the closing of the mints to the free coinage of silver

Convertible paper currency

What is convertible paper?

By *convertible paper currency* we mean notes for which the party issuing the notes will pay *specie on demand* Convertible paper currency ceases to be convertible when it ceases to be immediately and unconditionally convertible into specie

By whom is convertible paper issued?

(*a*) Convertible paper is generally issued by *banks* (*b*) In some countries, it is issued also by the *government* the paper currency of India and greenbacks of the United States are convertible paper

Convertible paper money issued by a bank is called by Walker *bank money* †

Advantages of convertible and inconvertible paper money compared

Convertible paper possesses the superior *convenience* and also to a certain extent the *cheapness* of other forms of paper money, while retaining the *comparative stability of value* characterising metallic money and also ensuring the automatic regulation of the money supply

(A) *Government Convertible paper*

Advantages

The fiscal advantage to the Government

(*a*) By issuing convertible paper, a Government can secure a certain amount of revenue without levying any additional taxes

The advantages to the people

(*b*) The advantages which the people derive from Government convertible paper are those which they derive from other forms of paper money viz the *saving of capital and labour* used in the production of gold and silver, the *prevention of the wear and tear of coins* and the *superior convenience of paper* for many kinds of payments

(B) Convertible bank paper

Convertible bank paper consists of bank notes issued by banks and convertible on demand into standard or legal tender money

The comparative advantages and disadvantages of (A) *government and* (B) *bank issues of convertible paper*

The respective advantages of issue by bankers and by government are thus discussed

(A) *Government convertible paper*

The following objections have been put forward against the issue of convertible paper by Government

(1) It has been said that the issue of paper money is not a proper function of the government The answer to this objection depends upon one's ideas as to the proper functions of government

† Walker—Political Economy

(2) Governments issuing convertible paper have often failed in the past to maintain its convertibility—so experience is against government issues

(3) The danger of excessive issue is greater with government convertible paper than with convertible paper issued by banks

(4) A strong objection against *government* ... is that it is ... *elastic* ... *than convertible paper issued by banks* ... bankers increase or diminish the volume of convertible paper according to changes in business demand and this cannot be done efficiently by government officials ignorant of business conditions

(B) *Arguments advanced against the issue ... by banks*

(1) If the business of note issue be ... by private banks and not by the government then the private banks ... have a great power. And this money power will often be used ... in their own interests and not in the interests of the people

Conclusion

The danger expected from ... generally undesirable for a government to issue notes ... *the banks should be controlled in the ... government* to protect the interests of the people

International paper money

"The use of paper instead of gold substitutes the cheapest in place of the most expensive medium, and enables the country ... to exchange all the gold which it before used ... for raw materials, utensils and food by the use of which ... its wealth and its enjoyments are increased" (Ricardo—Principles)

The gain to a nation from the substitution of paper money in place of gold will be multiplied many times ... when ... international paper can be realized to replace the present expensive ... of nations based on the precious metals. Labour and capital now engaged in producing gold and silver for money purposes would be saved, and a scientific regulation of the quantity of money and its value would be possible with international paper

* *Elasticity of paper money*

As ordinarily used, *elasticity of paper money* means *the power of the volume of money to increase with the increasing demand for money, and to decrease* ... *the decreasing demand*

It is desirable to have an elastic currency, a currency varying in volume with varying demand. In different localities there is an increased demand for money in certain seasons and in certain industries—e g agriculturists want an increased amount of currency for paying wages and also for small accounts during the busy agricultural season. With an elastic currency like bank notes under suitable conditions, the demands for extra currency in the busy season can be met without an extra strain on the money supply in other places and without the expense of transferring specie

The War has revived schemes of international paper money

Schemes of international paper are now but dreams and nothing more, they would require a higher degree of civilization and more cordial cooperation between nations than is possible at the present stage

Safeguards for the regulation of note issues (See Chapter on Banking)

The Banking theory and the currency theory of note-issue (See Chapter on Banking)

International Distribution of Money—the division of the world's supply of precious metals among different countries

(1) *The true theory about the distribution of money*

Like other commodities, gold and silver distribute themselves among different countries according to the demand for them, they will flow out from places where their value is low, to places where the value is high

The proportion which each country gets of the total world's stock of gold or of any new supply is determined by the strength of its demand as compared with the total demand of all the countries

II *The classical theory about the international distribution of money (the theory of Ricardo † and his followers)*

The answer given to this question by Ricardo and accepted by many writers is this The precious metals are so distributed among different countries as to accommodate themselves to the natural traffic which would take place if no such metals existed and the trade between the countries was purely a trade of barter

Suppose that there is a disturbance of money equilibrium, and a country (A) through increased production of gold in its mines gets a larger supply of money than it requires for its own exchanges (*i e* trade) The increase in the supply of money in the country brings

† ' Gold and silver having been chosen for the general medium of circulation, they are, by the competition of commerce, distributed in such proportions amongst the different countries of the world as to accommodate themselves to the natural traffic which would take place if no such metals existed, and the trade between countries was purely a trade of barter ' (Ricardo—Principles of Political Economy, Chapter VII)

about in it a lower value of money and increases the prices of commodities Now the prices in A being thus raised other countries (B, C, etc) will find it more profitable to sell their goods to A than formerly and so they will send to A more goods than they sent before —the imports of commodities into A from foreign countries will thus be increased by the rise of prices in A

On the other hand, foreign countries will now buy less in A than formerly on account of the increase of prices in A—so the exports from A to other countries will be diminished by the rise of prices in A

Imports will thus largely exceed the exports, and the country will have to export money to pay for the excess imports *Increase in the quantity of money in a country raises prices* in that country, and the *rise in prices* stimulates imports and discourages exports and thus brings about *exportation of the excess money supply* In a similar manner *a deficiency in the money supply of a country brings about a fall in prices* in that country, stimulates exports and discourages imports and thus brings about an *importation of money* to remedy the deficiency in the money supply *The territorial distribution of money among different countries is thus brought about through the* [illegible] through rise and fall in prices

† *Criticism of the Ricardian theory*

The Ricardian theory maintains that disturbances in the price level of a country are adjusted by the import or the export of the

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† *Kinley's criticism of the Ricardian theory of distribution of the money*

Prof Kinley in his 'Money' gives [illegible] criticism of the Ricardian theory, the substance of which is given below

(1) (*a*) Ricardo's theory assumes that a new supply of metals from the mines will go into the circulation without displacing other media of exchange and will raise prices

As Prof Kinley points out in actual practice a new supply of gold from the mines will be more likely to find its way promptly into the bank reserves of the great money centres and to move to foreign countries under the influence of international banking requirements without influencing prices at home

(*b*) Specie will be exported only if it is the cheapest article which the exporting country at the moment possesses

The usual case will be that a disturbance in the price level will be met by a change in the balance of export and import of goods [illegible] *movement of specie at all*

precious metals, and the following objections have been advanced against it (a) The Ricardian theory does not pay proper attention to the fact that a disturbance of price level is often adjusted by means other than the movement of specie (b) It neglects the influence of economic friction which often hampers specie movements, (c) and it ignores the modern credit mechanism which renders unnecessary in a large measure gold movements which would otherwise have taken place

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Again the amount of money which would be necessary to export, in order to readjust the general price level would be a large portion of the specie of the exporting country but it would be a very small part of the specie of the world as a whole and so *the remedy* for the restoration of the disturbed price level *is not adequate*

The Ricardian theory would apply only if all international trade was carried on by means of direct and immediate money payments and if all countries used the same standard metal

(II) The Ricardian theory is also modified by economic friction

(a) The Ricardian theory assumes that the flow of gold and the adjustment of prices are immediate and complete without expense As a matter of fact the flow of gold is not immediate and the distribution is not instantaneous

(b) An industrially backward country with undeveloped banking facilities will be able to get rid of its surplus money or to remedy its deficiency as regards the supply of money less easily than in the case with an industrially advanced country

(c) The rapidity and the equableness of the flow of the precious metals are affected to a certain extent by national and local customs and prejudices as well as by law

(III) The Ricardian theory assumes that the medium of payments between different countries is homogeneous, and consist of metallic money only

The fact is however quite different the medium of payment consists of metallic money and also credit *And the influence of the credit system greatly modifies the Ricardian theory of the distribution of metallic money chiefly in the two following ways*

(a) The more complex is the credit system of a country, the less metallic money relatively is needed by it for making its payments

(b) The movement of metallic money which would take place according to the classical Ricardian theory is rendered unnecessary in many cases by the operation of the credit mechanism

By what means is the transfer of bullion from one country into another is prevented in a large degree?

If trade between different nations was carried on only by payment of metallic money in exchange for goods, then there would be large transfer of metallic money from country to country to make payments for goods (and also to liquidate other kinds of international indebtedness).

International payments are however made largely through credit devices and only the balance is paid in metallic money. *The transfer of bullion from one country to another is thus prevented in a large degree by the developed credit mechanism of the different countries.*

(1) *Bills of exchange*

The transfer of bullion is rendered unnecessary in a very large number of cases by the use of bills of exchange. If there were no bills of exchange then [illegible] of metallic money would have to be transferred from country to country to make payments in international trade.

(2) *Bankers' [illegible]*

When there are not sufficient bills of exchange to meet the demands of the [illegible] debtors will make their payments to foreign countries by buying bankers' drafts on their correspondents abroad.

Merchants' drafts

The necessity of sending gold may be obviated to a certain extent also by merchants' drafts.

(3) *Transfer of securities*

Another device which renders the transfer of precious metal unnecessary in certain cases is the transfer of securities. The balance of indebtedness between two countries is much more likely to produce a transfer of securities than the transfer of bullion from the debtor country.

(4) The *debtor country may also continue in debt* to the creditor country or pay its debt by borrowing from some third country.

(5) An export of gold from the debtor country may be avoided or it may be diminished by a skilful *manipulation of the rate of discount*

(How the rate of discount is manipulated to stop foreign drains of gold is described in the chapter on the foreign exchanges)

Gold movements

Though the transfer of bullion from one country to another is prevented to a large extent by the developed credit mechanism of modern countries, yet there is some movement of gold from one country to another Through international trade and foreign exchange, the gold supply of the world is automatically distributed among the countries which need gold in accordance with the intensity of their respective demands for gold

Causes which lead to the movement of gold from one country to another

The chief causes which give rise to the movement of gold from one country to another are the following —

(1) A country mining precious metals will naturally export them as ordinary merchandise

Mines

(2) The price level of a country exercises a great influence upon the rate of exchange and the movement of gold If the price level of a country is lower than the international price level, then exports from that country will be encouraged and imports of commodities into the country will be discouraged, and so gold will be imported into the country to adjust the balance If the price level is higher than the international price level, then gold will be exported (It has been already seen however that the importation and exportation of gold will not be so full and free always as is assumed in the classical theory of distribution of metallic money)

Changes in price level lead to gold movements

(3) Other things being equal, a permanent increase in the home trade of a country will necessitate a larger amount of specie for carrying on the increased trade and this may cause an importation of gold

(4) A change in the ratio between gold and silver may cause the exportation of one or the other metal under the operation of Gresham's law

Monetary causes

(5) An improvement in the banking system of a country will enable it to carry on the exchange work of the community with a smaller quantity of precious metals and the *surplus metal will be exp[illegible]*

Banking causes

Again a disturbance of credit in a country may make a larger banking reserve necessary for a time and this is likely to bring about an *importation of [illegible]*

In normal times [illegible] *most powerful of the [illegible] the distribution of these [illegible]* raising the rate of discount the exportation [illegible] may be stopped or diminished and an importation of gold may be brought about

(6) The rate of interest influences gold movements

The amount of money needed by a country

The amount of money [illegible] lation, the amount and [illegible] the degree of perfection [illegible] is used

An increased volume of exchange requires a larger or more efficient medium of exchange but not necessarily more money. The increased volume of business will in many cases be met not by an increased quantity of metallic money but [illegible] changing the price level or by an extension of barter or by an improvement in the credit system or by a higher efficiency of money due to improved means of communication or by a combination of one or more of these things

(Each community will try to make its payments by the method which is least expensive under the given conditions. Metallic money is more expensive than credit money and so no commercial country will keep more gold than is needed to perform its direct money payments and to sustain its credit system. *The amount of metallic money in a country thus tends to a minimum*)

Theory about the value of money

The most abstruse topic in the theory of money is the determination of its value

The value of money refers to its purchasing power (*i e* the power of money to purchase other things in exchange for it)

Now the value of money is like the value of everything else a question of demand and supply

Supply of money

The supply of money depends upon the cost of producing the money and upon any other cause limiting supply The total supply of money or the money force available to do the exchanging work of the community is composed of two factors, (1) the amount of money and (2) the rapidity of circulation (If one coin performs five exchanges on an average in a week, and another kind of coin performs ten exchanges—the second coin has double the rapidity of circulation of the first coin)

Demand for money

The demand for money in a community depends upon the amount of exchanging work to be done by money All wealth that is produced is not exchanged through the medium of money Part of the wealth produced is directly consumed by the producers, part of it is exchanged by barter, and only a part (in a modern society, the greater part) is exchanged through the medium of money—and this constitutes the monetary demand in a community (Also it must be remembered that in a modern industrial society the use of credit largely reduces the demand for metallic money for the purpose of making exchanges)

† The value of money varies *inversely* as its supply and *directly* as its demand, other things being equal

The Quantity Theory about the value of money.

(1) The theory in its simple unqualified form is true only in a simple and primitive state of things

The quantity theory in its simple form states that the value of money falls proportionately (and the price level rises) *with an increase in the quantity of money and that the value of money rises proportionately* (and the price level falls) *with a decrease in the quantity of money*

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† The demand for money at a given time in a given society is constant, for this demand consists of all the commodities exchanged with money In this sense there is no elasticity in the demand for money The demand for money being constant, the value of money depends on the supply, on the quantity of money—all other things being equal This is the Quantity Theory

Mill remarks 'that an increase in the quantity of money raises prices and a diminution lowers them (i.e. prices of commodities) is the most elementary proposition in the theory of currency' but he is careful to point out that this unqualified statement of the quantity theory is true only in a simple and primitive state of things. [By a simple and primitive state of things we mean that there is no credit, that metallic money (gold and silver) is the exclusive instrument of exchange, there is no hoarding and no barter, and all commodities are for exchange, that the volume of business does not change and there is no change in the habits of people as regards the use of money. *Only in such a simple primitive state of society* we have that direct and intimate connection between quantity of money and prices which is asserted in the unqualified form of the quantity theory.)

The value of wheat rises or falls with decrease or increase in the supply of wheat. So does the value of rice, of salt, or of any other commodity. So does the value of money—but in the case of money only the change in value is *exactly* in inverse proportion to the change in quantity. If the quantity of money is doubled the value of money is exactly halved and if the quantity is increased four times the value exactly reduced to one fourth. This is because the demand for money is constant and has no elasticity.

(A) Short and long periods

(1) *Fisher*

The Quantity Theory in its scientific form would not hold true strictly and absolutely during transition periods. A sudden change in the quantity of money and deposits will temporarily in transition period affect their velocities of circulation and the volume of trade and a change in the quantity of money in such a period may not produce a proportional change in price.

Normally (i.e. in the long run when the transition periods are completed) changes in the quantity of money produce proportional changes in prices (i.e. in the general price level). Fisher has proved that under such conditions a change in the quantity of money does not affect velocities or the volume of trade and so far as the quantity of money is concerned its effect on prices is strictly proportional—variations in money supply produce proportional changes in prices.

(2) *Taussig*

"*For short periods* even for many years it is often difficult to trace any connection between the quantity of specie and prices.

On the other hand in the long run a relation between the volume of specie and prices is to be discerned while the precise quantitative relation between prices and the total purchasing power in terms of money remains unshaken." (Principles)

In complex modern industrial societies, where credit is used as a means of purchasing power and where we have to take note of other factors like hoarding, barter etc the connection between prices and the quantity of metallic money is not so direct as is stated in Mill's 'elementary proposition', and so to such societies the quantity theory in its unqualified form does not apply

(2) The 'scientific' and developed form of the quantity theory (stated with proper qualifications to suit modern conditions and as accepted by modern economists)

The quantity theory must be rightly stated with suitable limitations to make it applicable to modern industrial countries with a developed credit system and with changing industrial and monetary conditions And in a properly qualified form, the truth of the theory is admitted practically by all modern economists

We may state the law thus—**other things being equal** *the value of money falls proportionately (and the price level rises) with an increase in the quantity of money and the value of money rises proportionately (and the price level falls) with a diminution in the quantity of money*

The quantity theory is thus true under certain hypothetical conditions

The qualification 'other things being equal' is highly significant and extremely important

The hypothetical conditions implied by 'other things being equal' are the following —

(1) *The volume of trade*, (*i e*, the amount of exchange work to be done by money) must remain the same, in other words the demand for money *must remain the same*

(An increase in the volume of trade means an increase in the demand for money, and a decrease in the volume of trade leads to a decreased demand for money)

(2) *Barter*

The amount of exchange work done by barter must also remain the same (An increase in the volume of exchange work done by barter will lead to a smaller demand for money)

(3) *Credit*

There must be also no change in the business habits of the people and no change in the *use of credit* (Other things being

equal, an increased use of credit will lead to a smaller demand for money, and so will have the same effect upon the value of money and prices as an increase in the supply of money. (The increased use of credit comes from [illegible] banking facilities, etc.)

(4) *Rapidity of* [illegible]

The average rapidity [illegible] *of credit must remain unchang*[illegible]

(An increase in the [illegible] dation enables the money of a country to [illegible] exchange work with the same amount of [illegible] and so has the same effect upon the value of [illegible] in the supply of money. Increase [illegible] development of means of [illegible] development of banking facilities etc.)

Finally we must re[illegible] of precious metals is not used as [illegible] and part is used for industrial purp[illegible] of gold in industries would diminish th[illegible] as money. Gold is distributed b[illegible] uses so that the purchasing power of [illegible] value of an ounce of gold.

The cost of the [illegible] **relation to their value**

Does the value [illegible] of production? No.

"The durability of th[illegible] and the chance di[illegible] of the precious metals [illegible] tion [illegible]

"It is not so true that [illegible] that current value de[illegible] and shall become the [illegible] in capital

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The value of paper money

"It is on this principl[illegible] paper money may b[illegible] whole charge [illegible] value, yet by limiting its quantit[illegible] has no intrinsic denomination of coin or of bullion in th[illegible] as great as an equal quantity of paper money the value of pap[illegible] money can be kept on a par [illegible] that of metallic money."

The relation between the value of inconvertibl[illegible] and its quantity sometime expressed thus —

An increase in the quantity of money increases proportionately prices (and lowers the value of money), and a decrease in the quantity of money lowers proportionately prices (and increases the value of money)—only when other things are equal, in other words only when the volume of trade, barter, the use of credit and rapidity of circulation of money (and also of credit) remain unchanged. The influence of the quantity of money on the value of money may and is however often counteracted by changes in these other things viz. trade, barter, credit and rapidity of circulation. For example, when the quantity of money is doubled, if at the same time the volume of trade is doubled——the increase in the quantity (supply) of money will have its influence counteracted by the corresponding increase in the volume of trade (demand for money) and there will be no change in prices and in the value of money.

Symbolical expression of the theory of the value of money

(a) Fisher's formula

Prof. Fisher sums up the quantity theory in the following formula

$$\frac{MV + M^1V^1}{T} = P$$

In this formula

T = the trade, i.e., the quantity of exchanging work to be done

P = the price level of commodities

M = quantity of money

M^1 = the quantity of credit (According to Prof. Fisher M^1 bears a

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Other things being equal, the value of inconvertible paper varies inversely as its quantity. Such a theory about the value of inconvertible paper though generally accepted is not strictly true in all cases. An excessive issue of inconvertible paper will destroy the confidence of the people and the value of inconvertible notes will then depreciate more than in proportion to the increase in quantity. When inconvertible paper has driven metallic currency entirely out of the circulation even then it will have value provided it remains legal tender for certain purposes, e.g. the payment of taxes etc. If it ceases to be legal tender then its value may fall to zero and it will be replaced by natural money.

Other things being equal' here means that the total quantity of commodities has not changed, and that credit transactions and the rapidity of circulation of paper money are constant.

definite proportion to M, and the proportion of M to M in any country depends upon the concentration of population, scale of business systems of payment in use *etc*)

V=velocity of circulation of money

V^1=velocity of circulation of credit

The formula means that given T, V, M′, V′, (*i, e* the volume of trade, the velocity of circulation of money the amount of credit and the velocity of circulation of credit—all things remaining the same), P (prices) rises proportionately with an increase in the supply of M (money), P falls proportionately with a decrease in the supply of M

If M is trebled then P will be also trebled if M is halved (if the quantity of money is reduced by half), then the price level will be also halved

Other things being equal, P the price level (of commodities) depends upon the quantity of money and varies directly i.e. ~ Quantity

(b) Prof Chapman s formulæ

The theory of the value of money is summed up by Prof Chapman in the following formula

Let

P=Purchasing power of money, (note that in Fisher s formula P means another thing *viz* price level of commodities,)

T=Trade *i e*, the quantity of exchanging work to be done in a definite period (say, one year)

M=Quantity of money ounces (an ounce of gold in coined form is called a money ounce)

V=Velocity of circulation of money ounces M′=amount of credit money
V′=Velocity of circulation of credit money

Using the above symbols Prof Chapman sums up the complete theory about the value of money in the three following formulæ

$$(1) \quad P=\frac{T}{MV+M'V'}$$

Given T, V, M′ V′, (the amount of trade the velocity of circulation of money ounces, the amount of credit money and its velocity of circulation—all these things remaining the same) P (the purchasing power of money) varies inversely as M (the quantity of money ounces)

(2) The distribution of the precious metals between monetary uses and industrial uses is given by the equation

P=G, when G is equal to the exchange value of an ounce of gold bullion

The purchasing power of a money ounce will equal the exchange value of an ounce of gold bullion Coinage being Free and gratuitous

(3) Finally

S=P, if S is marginal supply price of an ounce of gold

The purchasing power of a money ounce will equal the marginal supply price of an ounce of gold

* Statistical verification of the Quantity Theory

The Quantity Theory can be statistically verified Prices by the middle of 16th century rose to double or treble what prices had been in the beginning of 12th century, and this general rise of prices was due chiefly to the great increase in the supply of precious metals from the discovery and exploitation of America Again from 1890 up to the present, general prices have been steadily rising and the dominant cause of this is a largely increased supply of gold from South Africa Klondike etc

The quantity theory of money in its application to India

The quantity theory in its bald and unqualified form (namely that the value of money rises or falls proportionately with a decrease or increase in the supply of money) *does not apply to India* This is shown by an examination of Index Numbers Index Numbers indicate that the total currency in circulation increased from 100 in the year 1894 to 164 in the year 1912, but prices in the same period did not rise in the same proportion but rose from 100 to only 138 The fall in the value of money (and the rise in prices) has not been proportionate to the increase in the money supply

In modern India, thus the value of money does not depend only upon the quantity of money

The increase in the average rapidity of circulation due to improved means of communication etc, the increasing use of credit resulting from better banking facilities, a very considerable use of the precious metals for the purpose of making ornaments etc and for hoarding, changes in the volume of business—all these factors affect the influence exercised by the quantity of metallic money upon the value of money and prices in India So the quantity theory to be made applicable to India must be stated with suitable limitations and not in its unqualified form

Objections against the Quantity Theory

Objections have been advanced against the quantity theory

(A) Objectors to the Quantity Theory have sometimes maintained that prices should be regarded as causes rather than as effects High prices increase the supply of money, and low prices bring about a decrease in the money supply—changes in prices are the causes and not effects of changes in the quantity of money

* Fisher—The Purchasing Power of Money chapters XI, XII

This objection is entirely unsound.

"So far from its being true that high prices [illegible] increase [illegible] supply of money, it is true that money avoids the place and the time of high prices [illegible] the place and time of low prices, thereby mitigating the inequalities of price [illegible]." (Fisher—The Purchasing Power of Money, chap. viii.)

(B) The Quantity Theory makes the condition [illegible] "other things being equal." But other things are not equal in [illegible] modern [illegible] the [illegible] other things change, there are changes in the volume [illegible] and industry, changes in rapidity of circulation [illegible] which [illegible] not available in all countries) and immense [illegible] credit [illegible]. The part played by gold is very small [illegible] payments in internal and in foreign trade, and [illegible] emphasis on the influence of gold in relation to prices [illegible] proportion between gold and credit is also denied by opponents [illegible] the influence of gold upon prices [illegible] factor — this seems something like [illegible] harbour by the rainfall and the inflow of the rivers and [illegible] the tides.

Prof. Laughlin has already [illegible] and Prof. Nicholson is very critical about it.

Changes in the value of money

Appreciation of money means [illegible] value of money, an increase in its purchasing power.

Depreciation of money means [illegible] value of money, a decrease in its purchasing power.

When the supply of money is increased [illegible] an extent that general prices (of commodities) are raised—there is said to be an *inflation* of currency. When the supply of money relatively to the demand decreases to such an extent that prices [illegible] fall—there is said to be a *contraction* of currency.

Such contraction or inflation is said to be *natural* when it depends upon natural conditions affecting the supply of precious metals. When the inflation is due not to natural conditions but is due the action of Government issuing inconvertible paper or debased metallic currency in excessive amounts—then the inflation is said to be *artificial*.

Contraction by bringing about a rise in the value of money *injures debtors* who in repaying the same amount of money they borrowed return to the creditors a larger purchasing power in terms of commodities, and it correspondingly benefits creditors.

Inflation, on the other hand, by bringing about a fall in the value of money *injures the creditor class* in a community, and it correspondingly benefits debtors

Evils of Artificial Inflation

Artificial inflation resulting from excessive issue of inconvertible paper produces many evils and these have been described in page 28

Artificial inflation of this sort is also a great hindrance in international trade Foreigners have no faith in the depreciating paper money of another nation and so the foreign trade of the country is injuriously affected

The great world-war just finished has brought about the issue of enormous quantities of inconvertible paper money by different governments, and this has led to inflation and all its evils

Causes of appreciation

We have an appreciation of the value of money when the same quantity of gold buys a larger number of goods than before, and this appreciation may be due to different causes *e g*

(1) The quantity of money remains fixed, but there is an increase in the supply of commodities

(2) The quantity of money has diminished, but the volume of goods remains the same

(3) The quantity of money and volume of goods remain the same, but there is a diminished use of credit or barter throwing more work upon the existing supply of money and thus increasing the value of money And so on

The increased supply of commodities will be often due to better methods of production and the diminished supply of precious metals for monetary purposes may be due to exhaustion of mines or to economic conditions making the mining industries comparatively unprofitable or to wars interfering with mineral production in a country or to an increased demand for gold in other countries for monetary or for industrial purposes etc

Causes of depreciation

We have depreciation of the value of money when the same quantity of gold buys a smaller number of the units of goods than before

And this depreciation may be due to different causes *e g*

(1) The quantity of money remains fixed, and there is a decrease in the supply of commodities This happens very rarely

(2) The quantity of money has increased, but the volume of goods remains the same This is more commonly found

(3) The quantity of money and volume of goods remain the same, but there is an increased use of credit and barter throwing less work upon money and bringing about a fall in the value of money

Effects of changes in the value of money

Different effects of appreciation under different conditions

If the appreciation is due to an increase in the supply of goods due to better methods of production, quantity of money remaining the same———then society has gained in greater producing capacity, and also an increased consumption of goods by all classes

If the appreciation is due to a diminution in the quantity of money, the quantity of goods remaining the same, then the total social satisfaction remains unchanged

Appreciation of money and falling prices

(A) Advantages of appreciation

(1) The creditor (though getting back from the debtor the same amount of money) will now get from the debtor a higher value in terms of commodities because of the increased purchasing power of money The debtor loses, but he may get some compensation for his loss in a diminished rate of interest

(2) Persons with fixed incomes gain by an increase in the purchasing power of their incomes

(3) Wage earners The wage earners gain because the same money wages will now buy more commodities on account of the increased purchasing power of money

The normal case of falling prices

The normal case of appreciation of money and falling prices, is that of a progressive community with a growing population producing at a gradually decreasing cost of production on account of improvements

Under these circumstances persons with fixed incomes, (i e persons getting fixed salaries or pensions) gain through the falling prices The same income will now buy a larger number of units of commodities

The *entrepreneur* will gain first from the diminished cost, then the *capitalists* then the *consumers* and finally the *wage earners* The decreased cost of production stimulates enterprisers by increased profits and increases their demand for capital and forces up the rate of interest—thus the capitalists benefit The competition between producers makes them lower prices and thus gives the consumer an advantage and at the same time it leads them to offer higher wages to labourers

(B) Disadvantages of Appreciation

Appreciation will produce serious evils if it discourages production and increases unemployment, then labourers will suffer greatly and also capitalists and entrepreneurs

Depreciation of money (and rising prices of commodities)

(A) Advantages of depreciation of money (and rising prices)

(1) *The rising prices (of commodities) increase the profits of the enterprisers and thus stimulate business*

(Profits of the producers are increased because cost of production does not increase as quickly as prices), and so the rise in prices increases the margin between the price of the commodity and its cost

Though the stimulation of production by rising prices sometimes leads to excessive speculation and a crisis, yet on the whole it does a considerable amount of good Prof Ely † points out that the *encouragement given by rising prices leads to the trial of new methods of production* and to a general freeing of the industrial organization and methods from the restraints of habits and traditions

(2) Creditors lose and *debtors gain* The debtor though repaying the same amount of money that he borrowed is returning a less value in terms of commodities because the purchasing power of money has fallen

† Ely—Outlines of Economics

Enterprisers work largely with borrowed money and as debtors they benefit by the fall in the value of money

The creditors however gain some compensation through an increased rate of interest When prices are rising the rate of interest generally tends to rise—the adjustment of the rate of interest to prices is mainly unconscious, but still producers are able and willing to pay a higher rate of interest with rising prices for their commodities and so there is a rise in the rate of interest

(B) **Disadvantages of Depreciation**

(1) A period of *rising prices* *often leads to a crisis* and its attendant evils In such a period profits are high The result is that there is excessive speculation loans are made freely even to incompetent entrepreneurs and there is inefficient work and over production

(2) How the *creditors* are injured by the rising prices—this has been already noticed in page 49

(3) *Persons with fixed incomes* (i e persons receiving fixed salaries or pensions), suffer because the same money income will now purchase a smaller amount of commodities than before

(4) Other things being equal *consumers* will *lose* because they will have to pay higher prices for commodities

(5) Money wages do not generally rise as quickly as prices, if prices rise faster than money wages at a particular time the real wages of labour are obviously falling and so the *labourers are injured*

Are rising falling or steady prices the best?

Some people hold that rising prices are best for a community

It has been already seen however that under certain circumstances rising prices lead to serious evils Most people will agree that the normal case of falling prices as described on page 49 is good for the community as a whole

Prof Chapman thinks that the prices which neither rise nor fall in general and are undisturbed by fluctuations, are best on the whole for a community Steady prices do away with the uncertainty which varying ... editors and debtors, entr... urs, wage

Measurement of changes in the value of money—Index numbers

The changes in the purchasing power of money are measured by Index Numbers of prices

At first sight it might seem impossible that changes in prices can be measured because the prices of different commodities are moving in different directions This difficulty however can be overcome by *averaging*—if the price of one commodity rises 30% and if the price of another commodity falls 30% we may say that on an average, prices of commodities have neither fallen nor risen We may take the prices of many commodities and averaging them find an average price for some standard year, and by comparing the average price in another year with the average price of the standard year, we may measure changes in average price of commodities, and from that we may calculate changes in the value of money

Changes in the value of money calculated through an average price

If the average price of commodities has fallen, obviously the value (the purchasing power) *of money has risen, and if the average price has risen the value of money has fallen*

Relation between the value of money and prices (i e the price level of commodities)

When 40 seers of rice are sold for Rs 4, then the purchasing power of a rupee equals ten seers of rice *When the price of the commodity has fallen* from Rs 4 a maund to Rs 3 a maund *the purchasing power of money has risen* from 10 seers to 13⅓ seers

To put it in a more general form, a *fall in the price level* (i e general prices of commodities) *means an increased purchasing power of money and a rise in general prices means a diminished purchasing power of money* The reciprocal relation between changes in the purchasing power of money and changes in the level of prices should be carefully remembered

How to construct a table of Index Numbers—general rules

The chief points in the construction of a table of index numbers are the following

(1) *The selection of a standard* or *basic period*

(2) *The selection of commodities*

(3) *The collection of price quotations* of the selected

commodities at different periods and the calculation of the ratios of these prices to the prices of these commodities in the basic period

(4) *Averaging* of the price ratios

(1) **Basic Period*

First, we take up the question of the basic period

One period is to be selected as the standard or basic period and the prices of other periods are to be compared with the prices of the standard period (The standard period may be selected as one particular year, *e g*, Jevons took the year 1871 as the standard period but it is now more usual among economists to select a longer period, a series of more or less normal years as the basic period for index numbers)

(2) † *Selection of commodities*

Another difficulty lies in the proper selection of commodities of which prices are to be taken The list of commodities must be as representative as possible

It must include important food grains, raw materials, manufactured commodities, the principal articles of production and consumption and trade in the country (In the various series of general index numbers prepared by different writers and Governments the number of commodities taken varies but it is never less than twenty)

(While constructing index numbers for special purposes we must [illegible] commodities, pay attention to the special purpose in view [illegible] calculating changes in the purchasing power of the money [illegible] of the working class we must select those commodities which [illegible] of the working man)

(3) *Collection of prices, and calculation of price ratios*

A third difficulty lies in the proper collection of prices and calculation of price ratios

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* According to Prof Marshall the best [illegible] to be the previous year

† The number of commodities selected varies [illegible] index number is based on 22 commodities, that of Sauerbeck on 45 commodities Falkner takes a large number and includes 2–3 [illegible] (Fisher, The Purchasing Power of Money chapter x)

In the collection of price quotations, care must be taken that the prices quoted for the same commodity in succeeding years are for the same quality of the commodity

We should take wholesale or retail prices according to the particular purpose in view Wholesale prices are more accurately known, apply to a larger area and are generally more convenient for general purposes For the purpose of showing the change in the cost of living of any particular class of people retail prices must be used

When the prices of the representative commodites in different periods have been collected, these prices must be expressed as ratios of the prices of the same commodities in the standard period

(4) *Averaging—question of weighting*

The averaging of the prices of the commodities in each period can be done in many ways

The simple arithmetical average yields practically as good results as index numbers obtained by other kinds of averages (weighted and unweighted), and it is much more easily calculated

It is best therefore to use the simple arithmetical average, and this is found for any particular period by summing the relative prices of the commodities and then dividing by the number of commodities

The average price may be calculated in the following different ways (1) The *arithmetical average* may be taken as has been done in the above para Sometimes the average price in a particular period is calculated by taking (2) the *geometrical average*, the nth root of the product of the relative prices of commodities Other kinds of averages are (3) the *median* which divides the relative prices of one particular year into two halves, half of the relative prices being above the median and the other relative prices being below it and (4) the *mode*

Again when calculating the average price for any year, the same importance may not be attached to all the commodities A commodity which is more important in the consumption or the trade of the country will not have the number 100 assigned to it but a higher number, the exact amount of weight to be given to each commodity depending upon its relative importance for the particular purpose in view This sort of average is called *weighted average*

Weighted index numbers seem to ~~the~~ be theoretically preferable, but numerous experiments have shown that different systems of weighted index numbers and a system of unweighted numbers yield almost the same results Weighting in actual practice thus does not seem to be of much importance, and unweighted index numbers are generally recognised by economists as serving all useful purposes

A typical table of Index Numbers

The actual formation of index numbers [illegible] is [illegible] in the following table. *The table is formed by following the general rule already discussed relating to the construction of index numbers.* [illegible] the purpose of simplifying the thing only six commodities have been taken [illegible] which would be quite inadequate in actual practice.

	1890			1900			1910		
	Rs	as		Rs	as		Rs	as	
Rice per bushel	3	0	100	2	0	[illegible]	2	[illegible]	[illegible]
Wheat per bushel	[illegible]	0	100		[illegible]	[illegible]	2	[illegible]	[illegible]
Steel per ton	60	0	100	50			[illegible]	0	[illegible]
Sugar per pound	0	8	100	0	[illegible]	[illegible]	0	10	[illegible]
Coal per ton	8	0	100	7	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Ice per lb	1	0	100	1	[illegible]	[illegible]	1	[illegible]	112[illegible]
Average price	600	6=100		[illegible]			[illegible]		105[illegible]

(1) In the above table the year 1890 is taken as the standard year. The prices of commodities in other years are compared with the prices of the same commodities in the standard year.

(2) Six commodities viz rice, wheat, steel, sugar, coal [illegible] have been selected as representative commodities.

(3) The prices of the representative commodities in the standard year and in other years have been put down in the table. The price of each commodity in 1900 and 1910 has been expressed as a percentage of the price of the same commodity in the standard year 1890.

[The price of rice in 1890 is Rs 3 and if the price of rice in 1890 be represented by 100, the price of rice in the year 1900 (Rs 2) will be represented by the figure 66⅔. Prices of the other commodities in other years are similarly expressed as percentages of the prices of those commodities in the standard year.]

Wholesale prices have been taken.

(4) The simple arithmetical average of the relative prices of commodities in each year has been used to form the average price of each year—the average price in 1890 is 100, the average price in 1900 is 106[illegible] and in 1910 it is 105[illegible]. The average price of each year is called the *Index Number* of that year.

In the above table of index numbers there has been no weighting of any particular commodity.

Calcutta prices

[illegible]onstruct a table of index numbers for prices in [illegible] 1913 (C U 1914)

(1) Then the year 1801 is to be taken as *the standard year* That year was however a famine year and not a normal one and so it would be better to take as the basic period the whole period from 1890 to 1899 which may be taken as a normal period free from abnormal fluctuations

(2) Calcutta is a port where modern economic conditions are more pronounced than in the rural parts of India and where the number of articles, for which price quotations are available is much larger than in the interior tracts

The representative commodities in Calcutta are rice wheat, dal, milk, ghee, mustard oil, potato sugar salt tobacco as articles of general consumption and articles of foreign trade like jute cotton hides oilseeds tea, coal, and iron etc It should be noticed that prices in Calcutta are related on the one hand to prices in the interior tracts of India and on the other hand to prices in world markets

(3) The arithmetical average of these prices will yield practically the same results as any other system of averaging and so the arithmetical average may be taken

Purposes for which index numbers are used (The services rendered by index numbers)

The purposes served by index numbers are thus given by Prof Kinley

(1) To find for the student of economic history a rough measure of changes in welfare from time to time, as shown by changes in the purchasing power of money

(2) To furnish a standard to keep general prices steady in order to keep trade stable

(3) To furnish a basis for the equitable discharge of long time debts

(4) To supply means for measuring the purchasing power of wages and incomes in different places among different peoples

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Prof Kinley's remarks on the best kind of index numbers for general purposes

For general purposes, changes in the value of money can be fairly shown by *a table constructed of the prices of articles of general consumption* This is because every one is a consumer

(1) In constructing such a table on the basis of quantities consumed, *raw materials should be excluded* except in cases where we cannot get accurate prices of the finished product (2) Wholesale prices are easier to get, and vary less as between different places and on the whole it would be better to *use*

It is comparatively easy to frame a separate table of index numbers for each one of these purposes but it is much more difficult (perhaps impossible) to form one table of index numbers which will serve all these purposes.

The increase in the production of gold

There has been a great increase in the production of gold in recent times—Prof. [illegible] points out that more gold was produced between 1850 and 1875 than from 1492 to 1850, and the production of gold in any 5 years since 1906 or any 2 years since 1902 was as great as the total production in the period first mentioned.

The *causes* of this huge increase in the production of gold are (1) the opening up of new mines in South Africa, in Canada, the United States and Alaska, (2) and the great improvements in mining methods.

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wholesale prices instead of retail prices in constructing the table of index numbers.

(iii) As to the *relative weight* to be assigned to each different commodity, the relative quantities produced at the given date [illegible] quantities marketed or consumed at the given dates.

(iv) The *wages of labour* employed in producing a commodity should not be included for the wages have been already allowed for in the price of the goods produced.

(v) *Rent in the economic sense* represents a differential advantage and does not affect the prices of commodities, so rent should be excluded from the table.

Limitations of Index Numbers

How far do index numbers satisfactorily measure changes in the purchasing power of money?

The value of index numbers for the purpose of satisfactorily measuring changes in the purchasing power of money depends upon the following conditions:

(1) Whether the standard or basic period is judiciously selected.

(2) Whether the c[illegible]luded in the table are representative [illegible] purpose in view.

The *effects* of this enormous increase in the production of gold are being widely felt in Europe in America and even in distant India linked to gold standard countries by her gold exchange standard

(*a*) Prices have risen on account of the increased supply of money and the question of high prices has been seriously engaging the attention of economists and politicians all over the world

(*b*) Wages have also risen but not in proportion to the rise in prices and so the wage earners are suffering severely

How a rise in prices due to increase in the supply of money affects different classes of people has been described on page 50 etc

The Tabular Standard of Value—a standard for deferred payments

In the modern business world the great majority of business transactions are done on credit, the payments are deferred they are made 30, 60, or 90 days after the purchase of goods Now steadiness in a standard for these deferred payments has been strongly advocated on the ground that such steadiness well prevent creditor as well as debtor from making undeserved gains and losses through changes in the value of money

Various sorts of standards of deferred payments have been proposed to realize this object, and one of the more important of these is the *tabular or multiple commodity standard* which has received a great deal of attention from politicians and economists

The Tabular Standard is based upon the Index Numbers of prices of commodities (As it is based on the prices of many commodities it is also called the *Multiple Standard*)

Under a Tabular Standard deferred payments would be regulated by an officially kept system of index numbers—*the principal of the debt would be increased with an increase of prices as shown by index numbers and it would be decreased with decrease in prices*

If a man borrows £1000 in the year when the index number of prices is 100 and if he has to repay it in a year when the

index number has risen to 120, he will have to pay £1200, to compensate the creditor for the fall in the value of money £1200 will now buy as much commodities—and will be worth the same as £1000 when the index number was lower.
V17 100

The argument in favour of the Tabular Standard

Advocates of the Tabular Standard declare that it maintains justice between creditor and debtor by providing for the repayment of the same amount of goods and not the same amount of money (the value of which may have changed.)

Neither the creditor nor the debtor is allowed to gain or lose through fluctuations in the value of money. The principal sum of the debt is increased or decreased according to decrease or increase in the value of money as indicated by index numbers. In this way the value of the debt in terms of commodities remains unaltered, the creditor always gets from the debtor the same value in terms of commodities which he lent to him.

Objections against the Tabular Standard

(1) A very important objection urged by Prof. Kinley is this: The tabular standard is not so just as it appears at first sight.

The tabular standard is not just

Under it the same amount of goods is returned to the creditor whatever may have been the changes in prices, and so the *benefit of a rise in price goes entirely to the creditor and the benefit of a fall in price goes entirely to the debtors.* The really just thing would be, however, to divide the benefit from rise or fall between creditors and debtors.

(2) With gold as a standard of value and all other forms of money convertible into gold, changes in prices are not likely to be rapid enough to do much injustice to either creditors or debtors,—so the *Tabular Standard becomes unnecessary.*

(3) The interest rate rises when the value of money falls and prices rise and it falls when the value of money rises and prices fall. In this way changes in the interest rate compensate creditor and debtor to some extent for losses due to rise or fall in prices and thus reduces the necessity for the Tabular Standard.

(4) The Tabular Standard is also not suitable for business debts for short periods in which price fluctuations are not large enough to require any correction.

The Tabular Standard also produces difficulties in the cancellation of bills of exchange because bills will have fluctuating values under the varying Tabular Standard

The conclusion thus seems to be that the Tabular Standard not necessary to secure justice for creditors and debtors in deferred payments for long periods and it is not suitable for business debts for short periods and the cancellation of credit documents like bills of exchange and notes

Other kinds of standards for deferred payments have been proposed and accounts of these are given in Prof Kinley's Money Chap 13 and in Prof Laughlin's Principles of Money, Chap 3

A good currency system is necessary to the economic prosperity of a country

Money in a good currency system would perform properly the different functions of money, that is it should be a good medium of exchange, it should be a good measure of value, and it should be a good standard of deferred payments

To perform money functions properly, *stability in the value of money is essential* A money the value of which fluctuates, will not be a good medium of exchange, will not be a good measure of values and will be a bad standard for deferred payments because the instability in the value of money will cause undeserved gains and losses to exchangers

Stability in the value of money prevents these undeserved gains and losses and so greatly stimulates exchange within a country, and the stimulation of exchange leads to an extension of division of labour and increase in the productive efficiency of the country and thus to economic prosperity

A country with a stable standard of value also benefits in international trade Uncertainty in the value of money discourages foreign trade

A good currency system should also economise as far as possible the use of metallic money for metallic money is expensive Paper

money is cheap, it is convenient for large payments and also for distant payments and the relative demands of the public for notes and coins mark the upper limit of the safe issue of notes. The issue of paper money within proper limits helps economic prosperity by its superior convenience and also by the metallic money which it liberates from the circulation.

A good currency system should also be *elastic*, i.e., the supply of money should expand with an increase in the demand for currency and should contract with a decrease in demand for currency. An elastic currency helps business prosperity by increasing the supply of currency when it is needed and by decreasing the supply when a decreased supply would be good for the community. This elasticity is secured generally by expansion and contraction of note issue and by expansion and contraction of bank credits.

Summary

(1) Precious metals [illegible] which make them better suited to serve as money than other commodities [illegible] they have displaced all other kinds of commodity money.

(2) Money serves [illegible] of value, as a standard of deferred payments [illegible]

(3) When two kinds of [illegible] circulate at the same time and together in excess of the [illegible] the [illegible] bad money tends to drive good money out of the circulation. (Gresham's Law.)

(4) Bi-metallism has been advocated [illegible] standard of [illegible] and also as benefiting [illegible] and [illegible] trade between silver using and gold using countries.

Bi-metallism has been and is being replaced [illegible] by gold monometallism because gold monometallism is better adapted to rich and progressive communities, is simpler and in the long run does not produce much greater fluctuations of prices than bi-metallism.

(5) Paper money is [illegible] convenient and provides in emergencies considerable financial resource to the Government [illegible] but the evils resulting from an over-issue of inconvertible paper are very great and such an over-issue should be carefully guarded against.

(6) Though the transfer of bullion from one country to another is minimised to a very large extent by the use of various credit devices, yet there is a movement of gold from country to country due to changes in prices by monetary causes, banking causes, changes in rates of interest [illegible]

(7) The value of money is like the value of anything else a question of demand and supply. Other things being equal and demand remaining the same the value of money rises or falls proportionately with the decrease or increase in the quantity of money.

(8) Appreciation has its advantages and disadvantages and so also depreciation n the whole, however, steady prices are the best

(9) The tabular standard has been proposed as a standard for deferred ments But it is not so just as it appears to be, moreover it is not essary for many kinds of deferred payments

Questions

1 What are the characteristics of good commodity money? Show that ld and silver possess these qualities in a greater degree than any other mmodity

2 Enumerate and classify the functions of money

3 Define money, Explain the difficulties that beset an attempt to define oney (C U 1915)

4 (a) What is coinage Free coinage? Gratuitous coinage? Brassage

(a) Explain standard money, token money, credit-money

5 State Gresham's Law with all necessary limitations

How does good money disappear? Does Gresham's Law apply to the dian currency system? (C U 1909)

6 (a) Outline the main arguments for and against bi-metallism? U 1910)

(b) In what ways is international bi-metallism superior to bi metallism actised by one country independently of other countries? Discuss hether and under what conditions, the system of bi metallic money is acticable (C U 1909)

Explain the compensatory action of the double standard

(c) State the case for gold mono-metallism? (C U 1910)

7 (a) What are the advantages of paper money and, what are its sadvantages?

(b) What are the evils, which result from an over-issue of inconertible paper?

What are the signs which indicate that inconvertible paper has been sued in excess?

8 Expound briefly the law of territorial distribution of money among ifferent nations (C U 1909)

9 (a) Mention the chief causes which give rise to a movement of old from one country to another

(b) By what means is the transfer of bullion from country to country revented in a large degree? (C U 1914)

10 (a) Discuss the following proposition 'The value of money ke the value of anything else, is merely a question of demand and upply' (C U 1912)

(b) "That an increase in the quantity of money raises prices and diminution lowers them is the most elementary proposition in the theory of currency and without it we should have no key to any other."—Mill

Examine this statement with special reference to Indian conditions and show how the theory is true only in a simple and primitive state of things (C U 1914)

(c) State the Quantity Theory of Money ... so as to make it applicable to complex modern industrial communities

10 (a) What are the purposes for which index numbers are used

(b) How would you construct a table of index numbers?

(c) How would you show the change in prices in Calcutta during the last 15 years by index number ... would you pay special attention? (C U 1914)

11 (a) What is appreciation? ... inflation ... contraction

(b) What are the effects of appreciation and depreciation on various classes of people (C U ...)

(c) Point out the causes and indicate the effects of the great increase in the production of gold within recent times

12 What is the case in favour of ... standard? Is ... standard really just? Is it necessary

13 Why is a good currency system important to the economic prosperity of a country (C U 1915)

CHAPTER II

CREDIT AND BANKING

What is credit?

(1) *By credit* we mean the power which one man has to induce another man to put economic goods at his disposal for a time on the promise of the debtor to pay the creditor at some future time. *Credit is thus an attribute of the borrower*

(2) The term credit is also used to refer to credit exchange or credit transaction. The power of borrowing manifests itself in credit transactions. In a cash transaction, present wealth is exchanged for present wealth; in a credit transaction present wealth is exchanged for future wealth

Gide, "*Credit is protracted exchange*, th... h is not complete until a certain period ...

time has elapsed' In a cash transaction there are two elements, (a) the goods sold (b) and the money paid for them in the present In a credit transaction payment is made at some future time, and so a third element, the *element of time* is added

Two forms of credit

Credit transactions can be divided into two chief classes (1) Sale of goods on condition of payment at some future date (2) Loan of money on condition of payment at some future time

History of credit

In ancient times and in the middle ages, credit existed but in a rudimentary form Loans were used in these times chiefly for purpose of consumption but they were not used to any considerable extent for purpose of encouraging production

Prof Hildebrand a distinguished economist of the German historical school holds that there are three stages in the economic evolution of society

(1) Natural economy, in which there is no exchange or exchange takes the form of barter

(2) Money economy, in which money is the medium of exchange

(3) Credit economy characterised by the use of credit in exchange transactions As a matter of fact all these viz barter, use of money and use of credit are found together more or less in the different stages of economic evolution, and so Hildebrand's classification can be accepted as correct only in the sense that each stage of economic evolution is characterised by the predominance of one or the other, though the other two are not completely excluded

Credit economy is only in its beginning, economists think that in course of time the system of credit will be so largely developed that it will do away entirely with metallic money

Can credit create capital ?

(1) † Mr Macleod's view

Mr Macleod has advanced a somewhat novel view by maintaining that credit creates capital and that credit instruments are real wealth true capital

(2) The correct view

The opinion that credit is a factor of production and can create wealth quite as well as land and labour—this opinion (*Macleod's view*) is clearly wrong

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† "Both money and credit are capital" "Mercantile credit is mercantile capital" (Macleod—Elements of Banking, Chapters IV and V)

Unlike Land and Labour, *Credit is not an independent factor or agent of production creating new wealth*. *It is only a method of production*, consisting in borrowing of capital by one person from another and the use of that borrowed capital in the work of production. (In the words of John Stuart Mill, credit is simply permission to use the capital of others.) When one man lends a capital of £1000 to another man, from the national point of view the capital is not doubled, new capital is not created by the mere fact of lending; only the capital that was in the hands of the lender is now transferred to the hands of the borrower. When a man sees his reflection in the mirror it would be absurd to say that there are two persons; and it would be equally absurd to say that there are two capitals each worth £1000 one in the hand of the borrower and the other in the hand of the lender, when the lender has lent £1000 to the borrower.

Advantages of credit

(1) *Credit helps production by rendering capital more productive.* Though credit is not a factor of production and cannot be regarded as creating capital by the mere fact of lending, still it performs very important services in helping production.

Persons who have much capital and not the ability to manage it, also labourers, servants and other persons who have not enough capital to start business separately, and minors, women and other persons who by reason of their age, sex, or occupation cannot engage in industrial enterprises—these persons by means of the credit mechanism are able to transfer their capital to entrepreneurs who will use their capital to the best advantage in the work of production.

In this way much capital which would have been wasted in unproductive consumption, or hoarded or used inefficiently in production is made available for efficient production by competent entrepreneurs.

(2) *Credit stimulates the growth of capital.*

Banks and other credit institutions offering to all classes rich and poor, suitable opportunities for investment promote thrift and encourage the accumulation of capital.

(3) Credit saves capital by taking the place of corresponding quantities of gold and silver as medium of payment. The economy

in the use of money thus effected enables a country to increase its productive capital

(4) Credit furnishes a more perfect and convenient means of payment in large sums and between distant places than is furnished by the precious metals and it thus saves time and labour

Evils of credit

The advantages of credit are many and are of very great service to society We must not overlook however the fact that the system of credit is attended with certain evils

Some have maintained that the use of credit for the purpose of production is always good and that credit for consumption purposes is always evil This though true in most cases is not always true

(1) Men borrowing for *consumption* purposes often become extravagant and extravagance frequently leads to fraud and dishonesty of various sorts

(2) As regards *production* credit sometimes leads to reckless speculation bringing mischief and ruin in its train Entrepreneurs use largely the capital of other persons under the system of credit, and having little of their own capital to lose, they, in many cases squander other peoples money in rash and speculative enterprises

Mechanism of Credit —Credit and its organization

The machinery by which credit operations are carried on consists of two parts

I The instruments of credit or the evidence of indebtedness, e g, cheques, drafts, bills of exchange notes etc

II The institutions of credit consisting of banks and clearing houses

1 Credit Instruments

Out of credit transactions arise different kinds of credit paper The most common of these are (1) bills of exchange (2) promissory notes (3) cheques and drafts

† The Cheque

A cheque is an order upon a bank by an individual or a

† A cheque is an order for payment so is a bill of exchange In fact a cheque may be regarded as a species of the genus bill of exchange—'a cheque is a bill of exchange payable on demand' (Withers—The Meaning of Money, Chapter IV)

Company holding a deposit in the bank, the order requiring the payment of a certain sum of money by the bank to the holder of the cheque or to the person named in the cheque

By means of the cheque, the depositor transfers part of his deposit in the bank to the person to whom the cheque is payable

The *element of cr t* in the cheque is that the person receiving the cheque must have confidence in the man drawing the cheque and in the bank upon which the cheque is drawn otherwise the cheque would not have been received by him in payment of his dues

The cheque is the simplest and most largely used instrument of credit, specially in England and the United States

(2) Draft

A cheque given by a banker upon another bank is usually called a banker's draft

(3) Bill of exchange

A bill of exchange is an order from a creditor A to a debtor B to pay a sum either to himself A or to a third party C

Suppose Adams has sold goods on credit to Brown, Brown having agreed to pay the price of the goods after three months Adams then will draw a bill of exchange upon his debtor Brown somewhat in the following manner

New York, 14th April 1916

To Brown (the debtor) London, England

Three months after sight of this bill pay to C or to order £100 for value received

Signed Adams (the creditor)

Adams is called the *drawer* of the bill and Brown the *drawee*

(4) Notes

Notes are of three kinds (*a*) Promissory notes issued by individuals and companies promising payment on demand or within a certain time (*b*) Bank notes (*c*) Government paper money

Bank notes and government paper money circulate freely as money but this is not the case with ordinary credit instruments which are intended to be used primarily in one transaction

(5) Book credit

This is very largely used especially in the retail trade When,

two firms grant each other book credit, there is no cash payment for each transaction, and only the balances after cancellation of credits and debits are paid in money This economises greatly the use of money

II Credit Institutions—Banks and Clearing Houses

The trade of banking has been exercised from very early times It existed in ancient India, Greece and Rome, and its immense development in the last two centuries has made it a subject of considerable complexity

Banks are dealers in credit Borrowing and lending are the two fundamental transactions of all banking business—*banks borrow to lend*

A bank has some capital of its own and it *borrows* money on its credit in the shape of deposits from depositors, and it *lends* its capital and deposits to persons with good credit lending at a rate higher than that at which it borrowed and thus makes its profit A bank is the debtor of its depositors and the creditor of those to whom it lends money

† Functions exercised by banks

The three important functions exercised by banks are

(1) *Deposit*

(2) *Discount*

Banks borrow in the shape of deposits and lend chiefly through discounting Borrowing and lending are the two fundamental banking functions

The deposit and discount functions are the most important functions exercised by *commercial banks*

(3) *Note Issue*

The function of note issue is not exercised by many banks, it is a privileged function belonging only to certain banks known as banks of issue

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† Functions of Banks

(1) *Taussig*

Banks act as agencies for the collection of savings and for investment,

Other functions exercised by banks are the following

(4) *Safe deposit*

At an early stage in the history of banking, people in England deposited their gold with the London goldsmiths for the purpose of safe custody Now people keep their jewellery, valuable documents and also securities in the safe custody of banks

(5) Lending money in other ways than by discount e g, overdraft which is a loan on the pledge of securities etc There are other banks (not commercial banks) which lend on mortgage of land, buildings and other kinds of property

(6) Payments rising out of international trade and other international transactions between different countries are made through banks by the purchase and sale of foreign bills of exchange (For an account of the work done by banks in Foreign Exchange see chapter on Foreign Exchanges)

(7) A few banks under state control or under semi public control act as the fiscal agents of different modern Governments

Such banks raise loans for their respective governments, anage the public debt, keep the government cash balances id exercise other minor functions in connection with the overnment

Definition of a bank

Prof Kinley thus defines a bank

"A bank may be described in general terms as an establishment hich makes to individuals such advances of money or other neans of payment as may be required and safely made and to hich individuals entrust money or the means of payment when ot required by them for use"

Banking Operations.

Deposits

How does a bank get the capital for its operations? The bank arries on its business partly with its own capital but that being nsufficient for its purposes it largely borrows money from the oublic

The banker borrows money from the public in the shape of leposits on which it pays interest

All depositors do not withdraw all their deposits from the bank it the same time and so the bank can safely lend a portion of these deposits How much the bank can lend depends ipon the normal withdrawals of money by the public If in a country normally 90 per cent of the total deposits of a bank are not withdrawn, clearly the bank can lend a portion of the deposits not exceeding 90 per cent of the total deposits and with the balance of 10 per cent can meet the normal demands for withdrawals by the depositors

The reserve of cash which the bank has to keep to meet the demands of depositors is called the *Banking Reserve* In different countries this varies from 5 per cent to as high as 35 per cent of deposits

The bank makes a profit by borrowing its deposits at a low rate of interest and lending them at a higher rate

There are (a) *cash deposits* as described above, (b) and also *credit deposits* created by banks

Credit deposits are created in the following way

A business man who wants to borrow brings to the bank a promissory note signed by himself and sometimes endorsed by one o more persons and if his credit is good the bank discounts the note and credits him with a deposit of the amount of the note, minus the interest charged by the bank on a loan The bank thus lends to the borrower by the creation of a deposit in favour of the borrower, and the borrower will be allowed to draw cheques upon his deposit After the period of the loan is over, the bank will recover from the borrower the amount lent

Ordinary commercial banking largely consists of the purchase of personal credit of business men and sale of banking credit to them by discounting their notes and creating deposits in their favour

Discount

A commercial bank cannot lend its money for long periods, it may be called upon to refund its deposits at short notice and so it can lend only for short periods

A commercial bank makes these short period loans by **discounting (a) the promissory notes of business men (b) also by discounting bills of exchange* In the modern business world goods are sold on credit and the manufacturer or the merchant draws his bill of exchange (representing the value of the goods sold) on the purchaser then the manufacturer or the merchant goes to a bank and by discounting the bill gets its present value, leaving the bank to realise the bill when its falls due, say after thirty days or sixty days or ninety days

A bank also lends money by making advances on securities and also in other ways

How much may the Bank lend?

As has been already pointed out, the amount which a bank ma

safely lend depends upon the normal withdrawals by depositors from the bank A bank must have a banking reserve sufficient to meet the demands of depositors and any resources beyond this reserve it can lend

Rate of Discount

The rate at which bank loans are made (i e the bank rate of discount) *depends upon the quantity of money held by the bank as a reserve* When the reserve increases, a bank lends more freely to business men and does this by lowering the discount rate and thus attracting borrowers, if its reserve is decreasing, the bank to protect itself will decrease the loans and increase the rate of discount (Business men speaking of "value of money" refer to this rate of interest or discount on short time business loans, and not to the purchasing power of money Plentifulness of money and easy money' in their language mean large bank reserves and free lending by banks to business men, 'tight money' means a small reserve and a restriction of loans)

The cheque system Clearing Houses

Deposits are used as the basis of the cheque system Persons having deposits at a bank make their payments by drawing cheques against these deposits and *the cheque system brings about a great economy in the use of money*

Suppose two persons, *A* and *B*, have deposits at the same bank *A* has to pay *B* £100, he will give a cheque of £100 to *B* on his own bank, and the bank will deduct in its account books £100 from the deposit of *A* and add £100 to the deposit of *B* *A*'s payment to *B* will thus be made without any transfer of metallic money and an economy of metallic money will be effected

In large cities, a further economy of metallic money is brought about by means of the *Clearing House* The customers of each bank send to it for collection on their account all cheques which they receive from their debtors drawn on other banks of the city Every bank in a large city thus receives every day cheques drawn on other banks, while other banks receive cheques drawn on it

A Clearing House *is a general organisation of the banks in a given place, its chief purpose being to cancel the mutual obligations of banks in the form of cheques* The representatives

of each bank bring daily to the *Clearing House* all the cheques it has received against other banks and each bank has to meet all the cheques drawn against it. *The balances are not settled between individual banks; they are settled between each bank and the Clearing House.* A balance is struck between the total sum of each bank's claims (in the form of cheques) against other banks and total claims (in the form of cheques) of all other banks against it. When the balance is against a bank, it pays that amount to the Clearing House, and a bank which has a balance in its favour receives from the Clearing House the amount of the balance.

An immense economy in the use of metallic money results from the Clearing House system. It has been calculated that in New York and London the balances paid and received in money by individual banks amount to less than 5 per cent. of the total transactions settled through the Clearing House.

Note issue

The chief function of a bank is to lend not its money or its capital but its credit.

A bank makes use of its credit by lending a part of its **deposits**—the depositors have confidence in the credit of the bank, they believe that the bank will return their deposits when required by them and they do not want their deposits returned all at the same time and so the bank is able to lend a part of those deposits. A bank may also lend its credit by issuing **notes**—it hands over to the borrowers from the bank these notes which they can use in their payments and these notes circulate because the credit of the bank is good.

If the public have confidence in the bank and have no doubt about the security of notes, then the note issue will be limited only by the habits of the people in respect of relative use which they make of note and coin. Notes are convenient for certain purposes and coin is convenient for other purposes, and *the*

relative demands of the public for notes and coin mark the upper limit of the safe issue of notes

Note-holders are usually given special protection

Legislation in different countries has usually given special protection to note holders (holders of notes) as distinguished from depositors

The reasons assigned for giving special security to note holders are two —

(1) Depositors are generally people of substance, while notes circulate among all classes including labourers and other people of small means

(2) A depositor deposits money in a bank by his own free choice and is presumed to have selected it after due deliberation Bank notes circulate among persons who have often no means of informing themselves as to the solvency of the banks issuing these notes and so note holders require special protection

Deposits as well as notes are part of the circulating medium of the country and deposits also must be made secure Proper safeguards for the protection of depositors have been established more thoroughly in the United States than in any other country One distinguished American economist suggests an insurance fund the insurance money to be paid by note issuing banks to a public guarantee fund out of which the deposits of a collapsed bank will be paid

Theories about note issue

The currency principle and the banking principle

There have been two schools of opinion in England on the subject of note-issue

(1) The followers of the currency principle for regulating circulation (2) The followers of the banking principle or bank liberty

(1) *The banking principle*

The writers advocating the banking principle maintain that the supply of bank notes ought to increase with the increasing demand in a country for an exchange medium *A bank should be allowed to issue notes in any amount to meet the demand of business* (without keeping a full reserve), *provided there is sound banking and the notes are convertible into coin* on demand They hold that there will be no over-issue and no inflation of prices if notes are issued on this plan, and they declare that such notes have every virtue belonging to metallic money with the added advantage of greater cheapness and greater convenience in use

Obviously this school regards bank notes as a form of bank's credit to be expanded or diminished according to the demands of business

(2) *The currency principle*

The advocates of the currency principle maintain a different view—they hold that the true principle of note issue is *to keep an almost full reserve of metal for all the notes issued, and to reduce the note circulation by a corresponding amount, as soon as a portion of the metallic reserve is lost by export of gold* to foreign countries. They assert that something more than sound banking is needed to give a country a secure note issue, they point out the issue of notes by banks on the banking principle may and will often lead to an over-issue of notes and inflation of prices.

Conclusion

Notes issued under the Currency Principle *secure*, free from danger of over-issue but *inelastic*.

The currency theorists make an increase in note issue dependent absolutely on an increase in the metallic reserve,—they make an expansion of the paper currency dependent not upon expansion of business demand but upon increase in the output of mines, this is wrong and unsatisfactory in principle paper currency should be elastic expanding with an increase in the demand for paper currency. Notes issued under the currency principle are perfectly secure being backed by a metallic reserve increasing equally with an increase in the note circulation, but the great defect of such a paper currency is that it is lacking in elasticity and so hampers industrial and commercial progress.

currency theory. *This can be done by following a modified form of banking principle providing at the same time adequate safeguards for the security of note issue.*

[The controversy between the currency principle and the banking principle agitated England in the first half of the 19th century, and Peel's Bank Charter Act of 1844 was a great victory for the currency theorists as it regulated English note issue under the currency principle.

The Bank Charter Act of 1844 has made the note issue of England secure, but inelastic. English bankers and business men soon found a way out of the difficulty created by the inelasticity of note issue by developing the cheque system which provides a perfectly elastic currency expanding readily with an increase in the demand for an exchange medium.]

Actual systems of note issue in different countries.

The different methods of regulating note issue as prevailing in different countries of the world in actual practice have been variously classified. The following classification is by Prof. Gide, a distinguished French economist.

(1) The first system consists in limiting the amount of notes in circulation by the amount of the reserve. This system prevails in England and was established by the Bank Charter Act of 1844.

[In India, the system normally is much the same as in England, and notes are issued on the Currency Principle; the Indian notes are however issued not by banks but by the Paper Currency Department of the Indian Government.]

(2) Another method consists in fixing a certain ratio between the amount of the reserve and the amount of the notes issued. This system is found in Belgium and in Germany but not in France.

(3) A third plan consists in fixing a maximum of issue—this system is practised in France and the maximum laid down there is five thousand million francs.

(4) The fourth plan is to compel banks to secure their note issues by means of reliable instruments of value (*e. g.* Government

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instead being a safeguard, is precisely the thing where the danger lies. "The amount of circulation continues the same, it is true, but its components are not the same; uncovered is substituted for 'covered' circulation, and the relation between metallic reserve and note circulation becomes less favourable." Pierson—Principles; also Andreades—the Bank of England, (Vol II Chapter IV).

Bonds or other valuable property) We find such a system is adopted in the United States where each bank has to secure its notes by an equivalent amount of Government bonds deposited in the Government treasury (in addition to other security)

It will be noticed that the third plan is based upon regulations limiting the amount of the notes the first and the second plans work by regulating *reserves* and the fourth plan secure note issues by *general assets of value* and not by metallic reserves

Reserves

The reserve kept by the banks to meet the claims of depositors is called the *banking reserve* The banking reserve may contain a certain proportion of notes and need not consist entirely of metal The proportion of the banking reserve to deposits is not the same in all countries and among advanced peoples like those of England and the United States, the proportion is as low as 5 per cent though it is as high as even 35 per cent in less advanced countries

The part played by the banking reserve in the home trade of the country is an important one

The part played by it during a crisis will be discussed in the chapter on Crisis

Gold reserve

Gold reserve is a reserve kept mainly for meeting the demand for gold rising out of international indebtedness or rising in connection with the international trade of the country The importance of this gold reserve in connection with the foreign trade of the country will be explained in the chapter on the Foreign Exchanges

The Banking Systems of different countries

(I) The Banking System of England

England has got a central bank, the Bank of England, which is the centre of the English banking system

The Bank of England

(A) *Its origin*

The Bank was founded in 1694 to finance William the Third's government It is the earliest and most celebrated of the great modern public banks and has had a long and illustrious history

"At the present day it still remains the most famous and from many points of view, the most original bank in the world

the development of the Bank is in no way different from the evolution and completion of all other social and political in-

stitutions in England And on these foundations the buildings themselves have been practically raised, curious in form no doubt, and irregular but remarkable in their solidity, imposing in their appearance and excellent in their practical working "†

(B) *Its organization*

The organization of the bank is regulated largely by Peel's Bank Charter Act of 1844 and partly by customary usages and traditions A striking and peculiar feature of the bank brought about by Peel's Act is the *complete separation of the note issue and the banking departments*—the issue department issues notes and the banking department manages the banking business and deposits but has absolutely no control over note issue

The Bank is governed by a body of directors numbering twenty six and the directors though practically self-elected have maintained the high prestige of the Bank and its predominant influence by the lofty standard of character observed by them

The Bank Charter Act of 1844

(1) What led to the passing of the Act

In the early days of banking in England many banks issued notes, not secured by a proper reserve of metal, and this frequently led to disaster The notes of some of these banks came to be worth only the paper they were printed upon, and so there arose a strong demand for a note issue, in which the note would be a bullion certificate, each pound of note being secured by a pound of metallic reserve

The Bank Charter Act of 1844 embodying the currency principle was passed by Peel to make the note issue perfectly secure The note was made practically a bullion certificate

(2) The provisions of the Act

The principal features of the Act of 1844 are the following —

(i) The Bank of England is allowed to issue notes up to a limit of fourteen millions (£14 millions) on the strength of securities without any specie basis, *for all notes above this amount the Bank must have a specie reserve of £1 for each pound of note issued* The note issue is thus made thoroughly safe

(ii) *The issue department and the banking department* of the Bank of England are *completely separated* The issue department is to issue notes and the banking department is to do banking business and to manage deposits, without having anything to do with note issue

(iii) Another provision aims at preventing any increase of note issue of joint-stock and private banks beyond the average at the time of the passing of

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† Andreades—The Bank of England,

the Act The object of the Act is to make the Bank of England ultimately the sole bank of issue

(3) The merits and defects of the Act

The Bank Charter Act has given England a perfectly secure note issue and this is undoubtedly a great *advantage*

The Act has however its *defects* (a) In ordinary times the note issue is inelastic (b) In a time of crisis the Act is unworkable and it has to be suspended

The Act has been suspended in 1847, 1857 in 1866 and virtually (though not in so many words) again on the breaking out of the last great war The suspension of the Act enables the issue department of the Bank, to issue notes without keeping a corresponding reserve of metal and the banking department, with the supply of emergency currency made available in this way, is able to allay panic in the time of crisis The members of the business public know that they will be able to get if necessary emergency currency from the Bank of England if they can offer good security and so confidence is restored and the panic is stopped

Its Functions

The functions of the Bank are many and important and they make it the greatest public bank of the modern world

(1) It has a *partial monopoly of the right of issuing notes* which in theory is destined to become complete in some future time (The limit of uncovered note issue laid down by the Bank Charter Act at 14 millions has been gradually raised till in 1907 it amounted to about eighteen and a half millions Notes above this limit are issued under the currency principle and are secured by a full reserve of metal)

(2) The Banking Department (which is completely separated from the Issue Department) is a pure bank of deposit the most important bank of deposit in the modern business world, and it is the *centre of a vast system of deposit banking*

The Banking Department in addition to other deposits keeps a portion of the deposits of banks And so it *has to keep the reserve* upon which other banks draw in time of danger, the reserve *which the business community regards as the support of the entire banking system of the country*

The Bank of England thus looks after the banking safety of the whole country

(3) The Bank of England by manipulating its rate of discount *controls* to some extent the *market rate of discount* all over England

(4) By raising and lowering the rate of discount, it controls the movement of specie from country to country and *maintains the central gold reserve of the English money market* (How the rate of discount is used to protect the central gold reserve—this is described in the chapter on the Foreign Exchanges)

(5) London is the clearing house of the world, and the centre of the London money-market (with its great system of joint stock and private banks) is the Bank of England so we may regard the Bank of England as the centre of the world's finance

(6) It keeps the balances of the British Government which has no other public treasury and manages its finances It keeps the registry of the English public debt and is charged with the duty of paying the interest on this debt

A semi-public character thus attaches to the bank though it is a private bank and not a government institution

To sum up

The Bank of England is a great bank of issue deposit and discount it is also the English bankers bank being the centre and regulator of the entire English banking system and money-market and at the same time it plays a very important part in the world's finance Nor must we forget to mention that the Bank is the fiscal agent of the British government

Some criticisms of the Bank of England

the business of the money market consists (i) in lending money now for the promise of money some day (ii) and also giving money here for money in another country through foreign exchange operations

Business men borrow in the money market for their business undertakings. The rate of interest charged is called *the price of money*.

(*b*) *Responsibilities of the English money market*

In England gold is unlimited legal tender, silver is legal tender up to £2 and bronze coins up to one shilling only. The Bank note is both cash and credit—it is cash for it is convertible into gold and it is credit because it is a promise to pay on the part of the bank. Like the bank note, the cheque is also cash and credit. A cheque is simply one class of bill of exchange—there are other classes, *viz* ordinary inland bills and also foreign bills of exchange. These are the principal forms of cash and credit in the money market.

The London money market has a twofold responsibility, national and international—(1) it has to supply credit and currency to its customers in England, (2) it has to meet foreign bills and drafts on London from all countries of the world, and it has to meet these bills and drafts in *gold on demand*.

(*c*) *Members of the money market*

The London money market includes (i) the *cheque-paying banks*, (ii) *bill brokers and discount houses*, (iii) *accepting houses* and *foreign banks*, (iv) and *the Bank of England* which is the centre of the whole system. The cheque-paying banks form the most important part; they create the cheque currency with which English commerce and finance is mainly conducted, they also largely control the price of money (the rate of interest) for day-to-day loans, and also the discount rates for bills of all dates. The bill brokers are retail dealers in bills of exchange and the discount houses are dealers in bills on a larger scale and are to a greater extent permanent holders of bills. Foreign producers who export goods to England and draw bills have their bills accepted by the accepting houses; and these accepting houses by lending their signatures and hall mark to these bills give them currency for the purposes of the London money market. The banks are also acceptors. And the centre of the whole system is the Bank of England

(d) *The Bank Rate*

Bank rate is the official minimum rate at which the Bank of England will discount bills. The bank rate is now ordinarily higher than the market rate of discount charged by other banks in the money market and ordinarily it does not control the market rate but when the foreign exchanges turn against England and gold is exported in large quantities the Bank of England takes steps to control the market rate and stop the drain of gold.

(e) *The convertibility of English money. The gold reserve*

In England the money that is used consists either of gold or of paper (e.g. Bank notes and cheques) that can be immediately converted into gold—'the essential and distinctive feature of English money is its unquestioned convertibility' (Withers). This immediate and unquestioned convertibility is found only in England and not in France, Germany or any other country, and this is one of the principal reasons as to why London is the centre of the world's finance; in London gold is always to be had, *London is the only free market for gold.*

As compared with its vast responsibilities in connection with the money market of England and also of the world's finance, London's gold reserve is insufficient. Bagehot (Lombard Street) drew attention to this sometime ago, and more recently Mr Hartley Withers in his remarkable book with a felicitous title "The Meaning of Money". Many remedies have been suggested and the problem still awaits a solution.

For the activities and functions of the English money market relating to the War and war finance, see Appendix on the War.

The War is now over. The maintenance of London as the financial centre of the world is of the highest importance to the British Empire—and for this the quick restoration of an effective gold standard (practically abandoned though nominally retained by Great Britain during the war) is wanted, and there should be no restrictions in London on the legitimate operations of foreign banks which are entitled to their proper share in the world's money market.

Some important features of the English Banking system

The Bank of England is the centre of a vast system of banking including the large joint stock deposit banks, the country banks,

the country branches of the London banks etc Some striking features of the English banking system are the following

(1) *The inelasticity of the note issue* (issued under the currency principle)

(2) *The immense ... of the system of banking and the large use of cheques* (English ... men have found compensation for the inelastic note ... in the great development of a highly elastic cheque currency ... them) Such a considerable use of deposits and cheques ... not found in France and Germany

(3) *The central ... position ... of the Bank of England* in the English banking system

II The Banking System of France

(1) The Bank of France ... central bank of the French system

(i) This bank has ... The French system is to have a ... of issue (... 5000 million francs), without any other limitation The metallic reserve kept amounts to ¾ or more of the note issue and the reserve kept is so large partly to make the bank ... strength and partly on the political ground ... of gold useful in a political crisis like war etc

The note issue of the Bank of France is elastic increasing and decreasing according to changes in demand for it

(ii) The Bank of France ... *bankers' bank* lending to bankers who in their turn lend to the commercial public.

(2) The Bank of France though a private institution is the fiscal agent of the government it keeps the public funds and manages the public debt.

(3) *The use of cheques is much ... in France* than in England and is confined chiefly to Paris and a few other large centres

(4) The French banks being restricted from issuing notes and there being also comparatively little use of cheques French bankers are *less enterprising* than bankers in England and the United States

III The Banking System of Germany

A brief account of the German Banking System before the War is given below

(1) In the German Empire, the central bank is the Imperial Bank or Reichsbank, and this though modelled upon the Bank of England has improved upon its model in certain respects, specially as regards note issue and financing the industrial development of the country

(i) The Reichsbank possesses *practically a monopoly of note issue* It may issue notes up to 550 million marks without covering them by cash, and for notes issued above this amount, it must keep a specie reserve for each mark of note issue

† The *note issue of the Reichsbank* is an improvement upon that of the Bank of England because it is *more elastic* The elasticity is secured by allowing the Reichsbank to issue fiduciary notes in excess of the limit on payment of a tax of 5 p c

(ii) The Imperial Bank supplies a foundation not only for the circulating medium but also for the structure of industrial credit

(iii) The Imperial Bank like other great public banks (Bank of England Bank of France etc) is managed with a view to public interest rather than the private gain of shareholders

(2) Some of the great German banks do the business of ordinary *commercial banks* and they *also* do *investing business* in Germany and abroad The German banks are efficient and enterprising

(3) The *use* of *deposits and cheques* in Germany though more developed than in France, is still much behind that of England

IV The Banking system of the United States

In the United States there is no central bank *banking* is *decentralised both as regards note issue*, and *also* to a considerable extent *as regards deposit*

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† During the war a school of economic thought has arisen in Germany with Prof Liefmann as its leading figure, and *Liefmann maintains that notes require no gold cover*, that notes can be issued on the security of good commercial bills and that notes can be well covered by 'staple raw materials of which it would be well to have considerable stocks laid up in case war broke out e g, copper, nickel, cotton, and so forth "

The government paper currency (greenbacks and gold certificates taken together) is in part a fiduciary issue, and in part based on a large gold reserve—thus practically following the note issue system of the Bank of England

The rest of the note issue in the United States is *practically by national banks, about 7000 in number* The national banks are allowed to issue notes on depositing Government bonds of equivalent value, as security at the United States Treasury and every bank has to keep at the Treasury a cash reserve of 5 p c of the note issue for securing the convertibility of notes on demand *National banknotes* are thus *perfectly secure* and the note-holders are very completely protected

(2) A very important feature of the American system is the great development of *deposit banking and the large use of cheques*

The rules laid down by the state for the protection of depositors are of a very systematic character The banks are divided into three classes (a) banks of the three central reserve cities, New York Chicago and St Louis (b) banks of reserve cities (c) country banks and each class has to keep a prescribed proportion of cash reserve for the protection of depositors

The country banks are allowed to keep a portion of their reserve in banks of the first and the second groups and the banks of the second group are allowed to keep a portion of their reserve in banks of the first group

The United States has thus got *a central reserve system*—the reserve banks of New York hold the same central position as the Bank of England as regards the keeping of the ultimate banking reserve of the country This leads to great economy in the use of money

The *cash reserves* in New York are *inadequate* and this is a serious element of danger from the standpoint of the banking safety of the country Other sources of danger lie in the dominance of *speculative influences in the New York money market and the inelasticity of banknote issues*

The American system of numerous competing enterprising banks leads to great enterprise and thorough diffusion of banking facilities but the want of a central bank makes these isolated and scattered banks helpless in time of crises

Among recent changes, the Federal Reserve Act of 1913 is of high importance, and during the war it helped to concentrate the nation's store of gold, to conserve its use and effectively to control

the gold outflow in connection with foreign trade Before this Act the nation's gold holdings were scattered among about 32, 600 banks 7600 National Banks and 25000 State Banks)

Central Bank

A central bank (such as the Bank of England, the Imperial Bank of Germany or the Bank of France) combines the following functions

(1) *A practical monopoly* of the privilege of *note issue*

(2) Keeping the *ultimate reserve* of *the country* and being the bankers' bank with which the other banks keep a portion of their reserves and upon which other banks will draw in times of difficulty

(3) Acting as fiscal agent of the Government, keeping the balances of the Government and managing its public debt

A banking system having such a central bank as its centre is called a *centralised banking system* and a banking system in which there is no such central bank is called a *decentralised banking system*

Centralised versus decentralised banking

(1) Note issue

Security of Notes

(*a*) A properly regulated centralised note issue will be secure and safe Decentralised note issue however under direct or indirect Government management makes the notes absolutely secure, as secure as the safety of the Government itself

(*b*) The *profit* which the Government makes from a monopolised note issue has been some times advanced as an argument in favour of such issue This profit is, however a small matter and its importance should not be exaggerated

The arguments which are really important will be about the important economic and fiscal services rendered to the community by the two different banking systems

Crisis

(2) *A central bank* with its unity of control and responsibility is in an immensely better position *to deal successfully with crises* than scattered isolated banks

(3) In normal times however a *decentralised banking system promotes banking facilities* within the community Numerous banks under the decentralised system enterprisingly competing for business generally do more to diffuse credit facilities in a country than a monopoly bank with a centralised note issue

Expansion of banking facilities

(4) *Fiscal and political advantages* — A central bank offers important fiscal advantages to governments It keeps the government funds, and raises loans for the government And in times of war it can offer very valuable help to the state by placing at its disposal the immense resources of such a bank

The danger of corruption and party bias in the high officials connected with the management of the bank must however be carefully guarded against

The question of a Central State Bank for India

The balance of advantages in favour of a central bank has led to a demand for a central bank in India as well as in the United States Opinions in India are pretty well divided on this question The advocates of such a bank (Mr Keynes and others) think that the arguments in favour of its establishment are very strong and are decisive

I Arguments advanced in favour of a Central Bank

The arguments can be summarised as follows —

A *The Indian Government will gain in the following ways*

(1) Government wants a central state bank to act as its fiscal agent (a) for keeping its balances (b) for managing its note issue, (c) for managing the public debt and (d) for controlling the regulation of foreign exchange which is done at present by the Indian Government The functions are now performed by the Indian Government But *they will be much better performed if they are combined with the function of banking by a Central Bank*

The Government does keep a portion of its cash balances with the Presidency Banks, but it has found by experience that it will not be safe to keep a much larger proportion of its balances with these private banks which may fail to return the Government deposits when the money is required by the Government So a public or semi-public bank in which the Government will have more

confidence is wanted The Government will also be able to help the Money Market substantially by lending its surplus balances through such a Central Bank

(2) Another advantage of considerable importance to the *Government will be that it will have a staff of expert financial advisers in the high officials of the State Bank*, at present the Government has to depend for financial advice largely upon intelligent amateurs of the Indian Civil Service

(3) A minor advantage would be that the *Government would be free from vexatious criticism on small details of financial business* which would be directed against the Central Bank looking after these things

(4) A *Central Bank would have larger opportunities* than are open to the Government for *pushing the circulation of notes* and it will bring about an expansion of note circulation by increasing the facilities available for convertibility

B *The advantages to the business world and to the people at large*

(1) A Central Bank will be able to undertake the function of exercising a general direction over the banking policy of the country, and thus *it will place Indian banking on a sounder basis*

(2) Some advocates of the Central Bank maintain that a central bank will lead to a great development of Indian banking and *its increasing branches will bring banking facilities* to *many parts of the country where at present they do not exist*

(3) When a Central Bank is established, the government will be in a position, *to lend the money market substantial sums through the central bank This will lower the bank rate* and will help business-men

(4) Some people maintain that the Central Bank through its local branches will be able *to help forward in a remarkable measure the progress of the co-operative movement* in India

(5) In India at the present moment there is a divorce between the responsibility for note issue and that for banking enerally This is a source of weakness, and is opposed to modern banking practice

The government (and not banks) issues notes and it keeps its reserve for securing the note issue The reserve for securing the

note issue is thus quite separate from the banking reserve kept by the banks and when the banking reserve proves to be insufficient there is no provision for strengthening it from the reserve for securing the notes

Finally the want of co operation between banking and note issue makes the Indian system inelastic and elasticity is one of the essential conditions of a good banking system This inelasticity, and also the divorce between the responsibility for note issue and that for banking generally will be removed by the establishment of a Central State Bank

Arguments against a Central State Bank for India

The proposals about the establishment of a central state bank have been criticised on various grounds *The objections are based partly on sheer conservatism* [illegible] *and partly on local prejudices and business jealousies* The more important of the objections are given below —

The note circulation will suffer

(1) Some opponents of the Central Bank are of opinion that the *note issue* controlled by such a bank will be thought less *secure* and so will be less *readily accepted* by the people than the notes issued by a government department as at present

(This fear about the note circulation does not seem to be well founded as the Central Bank will be a semi public institution and as such will command the confidence of the people)

The Central Bank will not help materially banking development

(2) The State Bank will be able to do very little for the development of banking in general and co-operative banking in particular What we need in India for securing a good system of banking is not a central bank but adequate and satisfactory laws for the regulation of banking

(The reply to this objection is that good banking laws are certainly required, and over and above these we want a central bank for the doing the work which is being done by central banks in England, France and Germany)

(3) Then there is a *difficulty as to where the bank is to be located* Calcutta wants it to be in Calcutta and Bombay wants it to

be established in Bombay and if established in Delhi it will be out of touch with business conditions (These are difficulties no doubt but surely some way can be found out of these difficulties) (4) The Exchange banks fear that the Central Bank will be a formidable rival

Difficulties about location of the Central bank

(5) Most businessmen in India seem to hold the opinion that *the exchange banks have financed the foreign trade* of the country *cheaply and efficiently* *Why try introduce a novelty?* It is best to let well alone

And its novelty

(The reply to this objection is that a new thing is not always a bad thing, especially if it has been well tested elsewhere and found satisfactory The Central Bank system has secured note issue and promoted sound and good banking in England, France and Germany and under proper conditions it will do the same thing in India)

The idea of a state bank though shelved for the present is a necessity for the future At this time of reconstruction after the great world war, the question is sure to come up for discussion and the establishment of such a bank will be of immense service to both government and the people

The value of banks—their social utility

A country secures very important advantages from a good system of banking—

(1) Banks economise greatly the use of gold in the exchange medium by issuing notes, and also by the cheque system

Economy in the use of gold

(2) Banks collect from thousands of depositors small sums which would have otherwise remained idle or would have been used in unproductive expenditure, and they make these sums available for productive enterprises This is done by saving banks, investment banks and also by commercial banks

Capital made more productive

(3) Large investment banks provide capital for industrial and commercial enterprises and thus help the industrial progress of the community

The money lent by *commercial banks* is lent for short periods only, but such short-period bank loans *promote*

industry by enabling manufacturers and merchants to get funds for their operations immediately by discounting their bills instead of waiting for the time when the bills will fall due and be paid by the debtors

(4) A very important service rendered by commercial banks is this They lend freely to capable business men and in this way the best business men even when they have no capital of their own are enabled to extend their business and to become leaders of industry

† Selection of the best industrial leaders

Society greatly gains by this increase in the efficiency of industry

(5) A large foreign trade with a small amount of metallic money is made possible by the foreign exchange operations of banks, and the foreign trade of the country is facilitated in many ways by a good system of banking

Facilitation of foreign trade

The entire industrial and commercial organization of a modern community is intimately bound up with its banking system The work of production the internal as well as the external trade of a country, they all depend very largely upon banking facilities

The stability of banks and their prudent and at the same time enterprising management are absolutely essential to the industrial progress of a country

Credit and prices

What is the influence exercised by credit on prices? Does credit affect price in the same way as is done by money? Or is it done in any other way? And in what way? This is one of the highly controversial topics of Economic Science There is a multitude of theories on the subject, and some of the more important theories are given below

(It is to be noted that this subject has been approached by economists in two ways (*a*) The creation of credit paper

† In Bagehot's expressive phrase a banker is a kind of *solvency meter* Some of the wisest heads (i e bankers) in England pass their time thinking whether other people will pay their debts—they lend to people who have business capacity and will be able to repay and thus help the development of industry

has been regarded as increasing the supply of the medium of exchange and the influence of this increased supply on the level of prices has been considered (*b*) Credit purchases have been regarded as additions to the demand for goods and the effect of this increased demand for goods on prices has been examined)

Credit and prices

(1) Credit has no influence on prices

(*a*) *Walker*

The general level of prices is determined by the supply of and the demand for the standard medium of exchange On the level of prices thus fixed, credit transactions occur, and these *credit transactions* cancel one another ultimately without the use of money, and they *have no influence on prices*

(Prof Kinley point out that Walker's view is defective, that there is generally an uncancelled balance of indebtedness based on credit, and this uncancelled balance creates a demand for money and thus credit has some influence on prices)

(*b*) *Laughlin*

Credit demand taken as a whole cancels itself, *credit* demand has existed from the beginning of exchange side by side with money demand and it *has not any influence on prices differently from that of money*

Laughlin's view is open to the following criticism

If credit has no influence on prices because it is co-existent with the level of prices, similarly money can have no influence on prices

(*a*) *Mill*

(2) Credit influences prices to the same extent and in the same way as money (Mill)

Mill holds that credit is virtually purchasing power, and so credit has the same effect on prices as money

(Mill's theory, however, does not pay sufficient notice to the fact that in a credit transaction only half the transaction is completed now, the remaining half being completed only at some later time by the payment of money—so money is required for the completion of a credit transaction *"In other words, it is a question not simply*

of purchasing power, but of liquidating power" So credit cannot have the same influence on prices as metallic money)

(3) **Credit influences prices but not to the same extent as money**

The truth lies midway between the positions of Walker and Mill

And the correct view may be thus expressed Money is purchasing power and it is liquidating power to the same extent Credit is purchasing power, but it is not liquidating power to the same extent To serve as a basis for credit transactions, a certain quantity of money must be kept as a reserve and this reserve is withdrawn from the circulation and is not disposable for cash transactions The credit tends to raise prices by increasing purchasing power, and the reserve tends to lower prices by withdrawing metallic money from the circulation The amount of credit is greater than the amount of the reserve and so the net result is that *credit raises prices to a certain extent* (but not to the same extent as is done by the same amount of metallic money)

(Taussig's view

(a) In some cases credit instruments only postpone the use of money without serving as complete substitutes for money A purchase on credit has the same *immediate effect* on prices as a purchase with cash When some purchasers are offering money for goods, and other purchasers are buying goods on credit the influence of credit is to increase the demand for goods and thus to raise prices Sooner or later the goods bought on credit must be paid for in money , and the money that will be used for making these credit payments will not be available for other transactions In those cases *in the long run* credit has no independent influence on prices

(b) In many cases credit instruments (e g bank notes) *serve as complete substitutes for money* , and affect prices as much as specie would

Crisis

Times of difficulty in the industrial situation or the financial situation, when pressure becomes acute, are called crises

An *industrial crisis* means a depression of industry in one or more countries, often international in its scope, continuing sometimes for years and producing far reaching results in the life of the whole community.

The *financial crisis*, on the other hand, lasts only for a few days or weeks, affects directly bankers and commercial men and is primarily connected with questions of money, banking and credit.

The industrial crisis and the financial crisis are closely connected; they are really two phases of one and the same phenomenon. At a certain stage of the industrial crisis, generally a financial crisis begins and intensifies the situation.

Periodicity of Crises

The recurrence of crises at regular periodic intervals of 10 or 12 years has been frequently noticed by economists. The idea of periodicity is suggested by an enumeration of recorded years of acute commercial distress in the 19th Century—1815, 1825, 1836-39, 1847, 1857, 1866, 1878, 1890.

The doctrine of periodicity of crises is strongly held by Prof. Jevons among other economists. In his famous sunspot theory he holds that the periodic recurrence of crises is to be explained by the periodic recurrence of sunspots at intervals of 10 or 12 years. Sunspots affect the weather in all parts of the earth and influence the production and prices of corn and other things, and bring about crises. Jevons's sunspot theory has not been widely accepted.

The element of periodicity in crises is exaggerated by certain writers, but that there is some periodicity is undisputed.

Causes of Crises

To indicate the causes of any particular crisis is a difficult task and of course it is much more difficult to formulate a general theory of crises. One writer has counted about 230 explanations of crises and since his time the number has increased.

(I) Objective causes

The industrial crisis is due to a want of adjustment between production and consumption, to either overproduction or underconsumption.

This want of adjustment of production to consumption is found in the production of more commodities than can be sold, in excessive and unprofitable railway building etc

And this kind of maladjustment is prominent during times of rapid industrial changes

Climatic conditions bringing about extensive crop failures, wars and such other things bring about a general depression of industry often culminating into a crisis

(II) Psychological causes

Economists rightly lay great stress on the psychological factor in crises

During a crisis panic spreads, and so many fail who would not otherwise have failed Depression in the minds of business men continues even after the objective causes of bad trade have been removed and so trade languishes After a time business men recover their spirits Enthusiasm is catching trade revives rapidly till through an excess of sanguine enthusiasm business men rush into overtrading which again brings about a collapse

Course of a crisis

A crisis generally begins after a period of business prosperity when prices are high and there is plenty of credit and also plenty of employment for labour In such a period of prosperity business expands new enterprises are launched Suddenly comes a period of hesitancy and uncertainty

The new enterprises begin to find obstacles in their way There is scarcity of money in the bank reserves the rate of discount rises, and there is a collapse generally precipitated by the failures of some big bank or banks

Then comes the acute stage of financial crisis The banks are asked to pay cash to depositors and they are also asked by commercial men to give them loans to help them in meeting the crisis Commercial men who are unable to get loans fail, and when the crisis is a very severe one there are also several bank failures greatly intensifying the situation After that comes the period of industrial depression when business is sluggish and few new enterprises are started The banks gradually accumulate large reserves, the rates of discount become low, and there is again a revival of industry to be followed by a crisis in cyclic order

(1) Beneficial results of a crisis

The period of depression following a crisis does a real good by restoring the proper balance of different parts of the industrial organism by checking unhealthy business activity and bringing about better adjustment of production to consumption

(2) Evils of crisis and remedies

Crises have been called diseases of the economic organism

Crises cannot be entirely prevented so long as we have competitive industry and the credit system There will be crises and the most that we can do is to mitigate their severity as far as possible

(1) The integration of industry by making possible better adjustment of production to consumption tends to make crises less frequent and less severe

(2 Labour organizations increase the bargaining power of workmen and thus prevent the widening of the gap between wages and prices which leads to crises

(3) It has been suggested that the Government by constructing its public works in periods of depression should counteract in some degree the unemployment due to the industrial depression

(4) The psychological factor is based on ignorance , and so this cause of crises can be counteracted to a large extent by wide diffusion of knowledge among business men of the larger aspects of industry and the warnings of the past as embodied in economic history

(5) As regards the problem of the financial panic, the solution is to have a good currency and banking system with adequate reserves

The function of a reserve is to be paid out when necessary a panic must not be starved During a crisis, a bold policy should be followed as regards the reserve, and the reserve should be paid out in response to calls upon it, and the panic will be allayed

A great central bank with a high standard of duty and following a bold and generous policy in offering loans to solvent merchants and manufacturers temporarily embarassed by the crisis, such a bank has been found by experience to be the most effective agency in meeting such a situation The Bank of England is such a central bank

(12) Credit influences prices but it does not exercise the same amount of influence as money

(13) Crises are periodic and are due to maladjustment of production and consumption The influence of the psychological factor is important

Questions

1 What are the different meanings in which the word credit is used ?

2 (a) Can credit create capital ?

(b) What are the advantages of credit and what are its disadvantages ?

3 What is a cheque ? a bill of exchange ? a draft ?

4 What are the various functions performed by banks ?

Write a note on the clearing house system

5 (a) Give a short account of the currency principle and also the banking principle of note issue Give the provisions of the Bank Charter Act of 1844 What led to its passing ? (1911 H)

(b) Describe the actual systems of note issue in England, France, Germany and the United States

7 Describe briefly the English Banking system noticing any characteristic peculiarities and special features

8 (a) What is a Central Bank ? (C, U 1913) What are the advantages and disadvantages of centralised and decentralised banking ?

(b) Discuss the arguments for and against the establishment of a Central Bank in India

9 Discuss the nature of the advantages of a good system of banking to an industrial community (1611 H)

10 Examine the influence exercised by credit on prices

11 Write a note on crisis (C U 1912)

Indicate the causes of crises, and suggest remedies Does any good come out of a crisis ?

In other words *how are international values, (the values at which goods exchange in international trade) determined*? The solution of this problem is to be found by a proper application of the fundamental principles of demand and supply which apply to all cases of value

While discussing the values of commodities within the same country, we assume that labour, and capital are mobile and move freely from one part of the country to another, and the *normal value of a commodity within a country* under these circumstances *is determined by its cost of production within the country*

In discussing international values (as opposed to values of commodities within the same country) we assume that products move from one country to another but that labour and capital do not move so freely from country to country

This international immobility of labour and capital, gives the key to the theory of international values

Let us begin with a simple case Let us assume only two countries England and France are engaged in international trade, and they are carrying on an international trade in two commodities only *viz*, silk and woollen goods

The relative cost of production of silk and woollen goods in France differs from the relative cost of production of silk and woollen goods in England, and this difference is due to the fact that labour and capital do not move freely from England to France and from France to England

And it is this *difference in comparative values which leads to international trade*

Suppose in France the same cost will produce 15 yards of silk or 15 yards of woollen goods

And suppose in England the same cost is required for producing 15 yards of silk or 20 yards of woollen goods

England has the greater relative advantage in the production of woollen goods, and France has the greater relative advantage in the production of silk goods—so England will produce woollens and France will produce silks, and England will get from France the silks she wants in exchange for her woollen goods

A country tends to export things in the production of which it has a comparative advantage, and it tends to import things in which it has a comparative disadvantage

(i) *International values of woollen goods and silk will lie between the limits imposed by comparative costs* the ratio at which England will exchange woollen goods with silk from France will be between

15 yards of silk = 20 yards of woollen goods (†comparative cost of silks and woollens in England)

15 yards of silk = 15 yards of woollen goods (comparative cost of silks and woollens in France)

(ii) Suppose under certain circumstances, the ratio of exchange between the two countries is 15 yards of silk = 16 yards of woollen goods With an increase in the demand for silk goods in England, England will be willing to give more woollen goods in exchange for each 15 yards of silk——*the ratio of exchange* may become 15 yards of silk = 17 yards of woollen goods

or

15 yards of silk = 18 yards of woollen goods etc *according to changes in demand* for woollen goods in France and for silk goods in England

Within the limits imposed by comparative costs, the particular ratio of exchange between the two commodities *is thus determined by the intensity of reciprocal demand in the trading countries*

The ratio of exchange must be such that in the long run the total values of woollen goods and silk goods exchanged must be equal

In our illustration we took only two nations and two commodities for the purpose of making clear the essential principles involved

Now we enlarge our figure to life size In actual practice, we have trade not between two nations but between many nations and the commodities which are exchanged in international trade are also numerous But 'trade among any number of nations and in any number of commodities must take place on the same essential principles as trade between two countries and in two commodities

† Note that in comparing costs we compare not the costs of production of the same commodity in the two countries, but that we compare costs of production of the two commodities in England and we compare the costs of production of the same two commodities in Fran[illegible] The costs of commodities (forming the subject of international excha[illegible]) [illegible] same country are compared

To sum up —

International trade results from differences in comparative values due to international immobility of labour and capital

(i) *International values* — (*the ratios of exchange between commodities entering into international trade*) *are determined by the intensity of reciprocal demand within the limits imposed by comparative costs*

(ii) *The ratios of exchange must be such that the aggregate value of the exports of a country must equal, in the long run, the aggregate value of the imports*

A paradox and it explanation

An interesting and apparently paradoxical conclusion follows from the principle of comparative costs *A country may import things in which its labour is more effective than is the labour in the country whence they come* The United States can make linens more cheaply than Germany or Ireland, and can make flax fibres more cheaply than Belgium The United States do not however manufacture linens and flax fibres but import them from Germany Ireland and Belgium The reason is this The United States though possessing an advantage over these countries in the production of flax fibres and linens possess greater advantages in the production of other commodities, and so the country will devote itself to the production of those goods in which its superiority is greatest, and will exchange these goods for other imports in the production of which its superiority though real, is not so great

Barter and money theories of international value

In discussing international values, English economists generally regard International trade as the barter of commodities This is the method followed by J S Mill and Cairnes, and also Marshall, Bastable and Edgeworth

In his Principles Vol II Nicholson has preferred to treat international values in terms of money For the comparative merits of the barter and money theories refer to Bastable's Theory of International Trade (Appendix C)

Sidgwick's theory of international value—as dependent on cost of carriage

Sidgwick's theory of international value is different from the current theory of international value as held by Bastable, Marshall and other prominent English economists The current theory is that the peculiarity of international value depends upon the imperfect mobility of labour and capital between different nations, but Sidgwick maintains that international value depends not primarily on the imperfect mobility of labour but on the cost of carriage In international trade there is a double expense of (a) sending the commodities out of a country (b) and importing other commodities in payment for these exports, and according to

Prof Sidgwick the problem of international value consists in the determination of the conditions governing the division of this cost of carriage between the trading nations

Objections against Sidgwick's theory

As against Prof Sidgwick's view there is the fundamental objection that his theory seeks to determine the division of only one kind of loss (viz cost of carriage) in international trade and it furnishes no solution of the division of gain in international trade

Also the position of money is not satisfactorily treated by Sidgwick

Cost of carriage Import and Export Duties etc

The introduction of cost of carriage and also of import and export duties makes the problem of international trade more complicated but it does not alter its essential character To be quite accurate and comprehensive, we must say that *trade begins between two nations when values differ after cost of carriage and tariffs* (import and export duties *have been allowed for*

Cost of carriage, import and export duties and other hindrances to exchange reduce the advantages of international trade

Cost of carriage if high enough will prevent international trade Ordinarily it raises the value of a commodity in the importing country to a certain extent *The division of the charge for transport will depend on the readjustment of demand* which the change in values will probably produce

The advantages of international trade

(1) Economic gains

The benefits of international as of all exchange, lie in an increase of utility

With a given amount of effort, a nation gains a larger satisfaction by means of international trade than it would get in the absence of such trade

The general economic gains of foreign trade can be divided into the following —

As regards imports

(1) International trade enables a country to obtain by importation articles which cannot be produced at home It is in this way that Switzerland gets coal and all European countries get tea, coffee, tropical fruits

(2) Another advantage of international trade is that it enables a country to get by importation commodities which could be produced at home, only at a greater cost.

England gets by importation wine and silk much more cheaply than she could have produced at home.

(3) By importation a country is able to save itself from the grip of famine and scarcity when its own crops fail.

(4) International trade acts as a powerful check on monopolies and trusts and it prevents rapid fluctuations of prices.

As regards exportation.

(5) A country superior to another in many branches of production will devote itself to the production and export of commodities in which its superiority is the greatest and it will import the other commodities. In this way *international trade will raise the productive efficiency of a nation to its maximum; it will develop the nation's industries.*

(6) International trade by creating world wide markets greatly extends division of labour and large scale production. It makes each nation devote itself to those industries for which it is best fitted by its natural resources and aptitudes of the people; and so the *productive efficiency of all nations is greatly increased and the world, as a whole, gains.*

II. Non-economic gains (social, moral and political advantages).

(1) International trade brings men of one nation in touch with the men of other nations possessing different types of culture and civilization, and this leads to social, moral and political progress.

(2) Commerce is binding the different nations of the world by common economic interests. And so it has been maintained by many writers that international trade diminishes the chances of war, and the development of international commerce is one of the best guarantees of universal peace.

The titanic European conflict just finished shows that the extinction of war by the development of international commerce is yet very far off from realisation.

Disadvantages of International Trade.

The possible disadvantages of international trade to a particular country, are on a larger scale but are practically of the same nature

as the disadvantages resulting under certain circumstances from division of labour within the same country.

Importation has its dangers

(1) A sudden introduction of foreign trade and the influx of huge quantities of foreign imports will upset the industrial organization of a country. Labour and capital already engaged in the industries thus subjected to foreign competition may find it difficult for some time to transfer themselves to other industries. Some part of the capital may be lost.

Displacement of labour and capital in domestic industries

The labourers engaged in the industries ruined by foreign competition, *lose their employment* and suffer as they will not be able all of them to get other employments quickly.

(2) The consumption of certain commodities (e. g. opium, cocaine, certain kinds of liquors, etc.) affects very injuriously the physical and the moral welfare of the consumers, and the importation of these commodities is an evil of serious magnitude.

Importation of injurious articles

The dangers on the side of exports are the following:—

(3) The *specialization of industries* resulting from foreign trade *increases the chance of so-called over-production*.

When a country has an industry producing and exporting for a world-wide market, it is difficult to calculate exactly the amount that would be demanded in such a market—a war or any other grave disturbance of economic conditions may bring about a sudden decrease of demand, which will produce serious results.

Risk of overproduction increased

(4) The exportation of food-stuffs and other agricultural products may under certain circumstances intensify the action of the law of diminishing returns in agricultural countries.

Operation of Diminishing Returns

(5) When the product is an exhaustible one (e. g. English coal or Peruvian guano) the evil is more apparent. A not inconsiderable part of British industrial strength is based upon Britain's superb coal resources and an excessively rapid exhaustion of her coal mines may conceivably imperil British industrial supremacy.

Exhaustion of natural resources

Balance of trade Balance of accounts

The expression '*balance of trade*' indicates in popular language, the relation between imports and exports of commodities We see from an examination of the statistics of international trade that the imports and exports of a country are rarely equal In England, in France, and in some other old and rich countries the imports of goods exceed the exports and such countries are said in popular speech to have an *unfavourable balance of trade* In the United States, in Australia, in India the exports of goods exceed the imports and countries having such an excess of exports are said to have a *favourable balance of trade*

When we want to find out whether the foreign trade of a country is in equilibrium (i e whether its total credits and debits are equal) *we have to consider not* merely the exports and imports of goods and *balance of trade* resulting from these imports and exports, we have *rather to consider the balance of accounts* resulting from the total credits (claims) and debits (debts) of a country The total credits of a country include exports of goods (by which the country becomes the creditor of other countries) and many other things, the total debits of a country include imports of goods (by which the

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The Mercantilist ideas about foreign trade and balance of trade

The terms favourable and unfavourable balance of trade, are relics of old mercantilist theory The mercantilists held that the principal object of foreign trade was to import precious metals from foreign countries. A country exporting more goods than it imported would according to the mercantilist theory get a quantity of precious metals in exchange for the excess exports, and so an excess of exports was regarded by them as a *favourable balance* of trade, conversely a country importing more merchandise than it exported would, according to the mercantilists, have to export precious metals to pay for the excess imports, and so an excess of imports was regarded by them as an *unfavourable balance*

The mercantilist beliefs that money is the best form of wealth and that the object of foreign trade is to bring about importation of precious metals—these beliefs are now rejected by modern economists Again the mercantilists are wrong in maintaining that an excess of imports has to be paid wholly by exportation of metallic money, it is paid partly or wholly by other and more convenient means of payment, and a country does not get metallic money for the whole value of its excess exports of goods because it may have other debts which it may pay wholly or partly by its excess exports of goods

country becomes debtor of other countries) and many other things. The balance of accounts (or the true balance of international payments) resulting from the total debits and credits of a country is something quite different from the so-called balance of trade resulting merely from exports and imports of goods.

The credits and debits of a country

Important international claims and debts rise also in other ways than by exports and import of goods recorded in official government statistics and are known as *invisible* imports and exports*. These invisible imports and exports (of goods and services) though not included in the balance of trade must be taken into account when we want to find the true balance of international payments.

The following are the principal debits and credits of a country:

(1) *Exports and imports of goods.* A country becomes the creditor of another country by what it exports, and it becomes a debtor by what it imports. India exports generally more goods to England than it imports from England; on this account India is a creditor and England a debtor.

(2) *The cost of transportation* of goods by ships etc. (i.e. freight and insurance). England on this account gets very large sums from India and foreign countries—so England is a creditor, and India is a debtor; and these services of transportation are *invisible exports* in the case of England.

(3) *The interest on capital invested abroad.* Rich nations invest considerable amounts of their capital in other countries and they get interest.† England gets every year very large sums in this way as interest on foreign investments and is a creditor; and in this respect India, Egypt, Australia etc. appear as debtors.

(4) *Expenses of foreigners living or travelling in a country.* Countries like Switzerland and Italy, which are visited by tourists

* These exports and imports are called invisible not because they cannot be seen—often they can be seen well enough; they are tangible. They are called invisible because they are not recorded in the official figures of trade.

† "British foreign investments which now amount to some £3,500,000,000 are likely in future years to increase rapidly beyond that figure." (Hobson—The Export of Capital.)

in large numbers, get from them large sums as their expenses, India also gets certain sums in this way Again India has to pay large sums to foreign countries as expenses incurred by Indians studying, living or travelling in these countries

(5) *Banker's commissions etc*

Countries (like England, France) with bankers doing agency and financial work for merchants of foreign countries become creditors of these foreign countries for bankers' commission. On this account also England is a creditor, and India is a debtor

India has to pay every year the 'Home Charges' to England on account of pensions and leave pay of English officers and for Government stores etc in this matter England is a creditor, and India is a debtor

(6) *Government expenditure* in foreign countries *for diplomatic service, tributes, war indemnities, borrowing and repayment of loans or* the purchase of securities—they all must be included in calculating the true international balance

So the complete statement is that *the goods monies and services rendered by one country to other countries plus its credits and claims of all kinds will be balanced by the goods, monies and services received by the same country plus its obligations and debts of all kinds* It is in this sense that the total debits and credits of a country are equal

Imports and exports tend to be equal

The proposition imports and exports of a country must be equal is not true in the sense that the imports of commodities must equal the exports of commodities

We see that equilibrium is attained when the total credits of a country balance it total liabilities, and such an equilibrium may be perfectly compatible with an excess of exports or an excess of imports (of commodities)

The proposition is, however, true in the sense that *in the long run the total credits of a country must equal its total debits*

Significance of an excess of exports, and of an excess of imports

An excess of imports of commodities into a country may mean (*a*) the incurring of liabilities to other countries or (*b*) it may, on the contrary, mean a liquidation of past and present indebtedness to that country by other countries An excess of exports may mean (*a*) that one country is making other countries its debtors by this excess of exports or (b) it may mean that the

country by the excess exports is paying other countries interest on capital borrowed from them or remuneration for services rendered by them The excess of exports of commodities from India means the latter thing These excess exports enable India to pay interest on English capital borrowed by India and also to pay England for political and other services rendered by Englishmen, the services rendered by English officers English shipping and English bankers and so on

* Foreign Exchanges

The expression foreign exchanges is used to mean different things

(1) *The mechanism of payment in foreign trade is known as the Foreign Exchanges*

"*The machinery whereby payments are effected in foreign commerce is known as that of the foreign exchanges*" (Chapman) Payment is made chiefly with bills of exchange running for certain periods or with cheques which may be regarded as bills payable at sight

(2) Sometimes the expression 'foreign exchange' is used to mean the *rates of exchange*, at which foreign bills are sold When we say that 'the foreign exchanges' are moving against a country we refer to the rates of exchange

(3) The expression is also sometimes used to mean *foreign bills of exchange* When we say that the Exchange Banks of India buy and sell foreign exchange we mean they buy and sell foreign bills of exchange

Economising of metallic money in foreign trade

Even in the home trade the use of metallic money being expensive and also inconvenient for some purposes a very large proportion of payments is made through paper credit devices and the use of metallic money is economised to a very considerable extent The same thing happens also as regards the foreign trade of the country

to a wonderful economy in the use of metallic money in making payments in foreign trade

As compared with the enormous values of goods exchanged in international trade, *only a small amount of money is used, the greater part of the payments is made through transfer of obligations chiefly by paper instruments called bills of exchange,* money being employed only for the occasional settlement of the balances remaining after the cancellation of credits and debits

The operation of a bill of exchange A bill pays two debts

How are these bills of exchange used to make payments in international trade by the transfer of obligations ?

To understand this, let us see the operation of a bill of exchange between two countries, say the United States of America and England

United States		England
↓ (Exporter) A		C (importer)
↓ (Importer) B	⟶	D (exporter),

A and B are two merchants in the United States of America, C & D are two merchants in England Suppose A (an American exporter) has sold goods worth £1,000 to C— A has sold goods and has drawn a bill for £1,000 upon C representing his claim against C A in America is thus creditor of C in England to the extent of £1,000

Also suppose that D an (English exporter) has sold goods worth £1,000 to B D (an English exporter) is thus the creditor of B in America to the extent of £1,000

Now the bill will move in the way shown by the arrow marks in the figure given above

A will sell that bill for £1,000 and in this way he will recover the value of the goods sold by him, *A will thus be paid*

B will buy the bill from A because B has to pay £1000 to D for goods bought by him from D B will send this bill for £1,000 (drawn by A upon C) to D, *and D will recover the value of the bill from C* In this way B's payment to D will be made by using the bill drawn by A upon C

We thus see that *using the bill of exchange drawn by A upon C A's claim against C is paid also D's claim against B is paid Every bill pays two debts,* If there were no bills of exchange, then

C would have to ship metallic money from England to America to pay A and B would have to ship metallic money from America to England to pay D This *double shipment of money and the expense and inconvenience attaching to it are avoided by the use of the bill of exchange*, and B's transferring to D the bill representing C's obligation to A

In America there are thousands of exporters and importers and there are thousands of exporters and importers in England *Bills to the value of many millions will be drawn by American exporters upon English importers and will be bought by American importers to pay their English creditors* (English exporters), and through the use of these bills *a great economy in the use of metallic money* will be effected in making international payments

(An American importer will also sometimes make his payment to the English exporter by buying the draft of an American bank on a bank in England and by sending the draft to his English creditor)

"*The exchanges in question are exchanges of claims or debts*" †

Balancing of credits and debits between two nations.

The payments in international trade between two countries (say England and America) will very largely be made through the balancing of mutual debts and credits by bill of exchange etc, and metallic money would be required only for the payment of the balance remaining after the balancing of credits and debts

Further economy of metallic money effected by the balancing of credits and debts between many nations

A further economy of metallic money in foreign trade is effected The method of payments by balancing accounts is confined not to two nations but is in operation among all industrial and commercial peoples If America owes England five million pounds (as in the above example) after the balancing of accounts and if America is at the same time a creditor of another country to extent of five millions after balancing accounts with that country, then obviously America can pay her debt to England by transferring America's claim against the third country to England

When we consider all nations trading together, the total credits

† Goschen—Theory of the Foreign Exchanges

of a nation against all other countries are utilised to pay its total debits to all other countries by the use of bills of exchange, drafts etc, and if the total credits are less than the total debits, then the country has to pay metallic money for the excess debits or it has to continue in debt

Some terms and explanations

Bills of Exchange, foreign bills, sight bills, long bills etc

Bills of exchange, as already explained in the chapter on 'Banking' are drawn by merchants and manufacturers upon persons to whom they have sold their goods and these bills represent the claims of these merchants and manufacturers against the persons to whom they have sold their goods

The *drawer* of the bill is the person who draws the bill, the creditor to whom the money is owing, and the debtor, who owes the money is called the *drawee* When the debtor signs the bill to signify his acknowledgment of the debt, he is said to *accept* the bill

Bills of exchange are divided into (1) *Inland bills* of which the drawer and the drawee live within the same country

(b) *Foreign bills of exchange* of which the drawer and the drawee live in different countries In the chapter on 'Foreign Exchanges' we shall have to deal with these foreign bills of exchange We must also note the difference between a *sight bill*, which is a bill payable by the drawee at sight and a *long bill*, which must be immediately accepted by the drawee and paid after a prescribed period, say 30, 60 or 90 days A bill is said to be *discounted* when it is sold to a third person for its present value, the third person deducting from the future value of the bill something as interest

The bankers are middlemen as regards the purchase and the sale of these bills From whom do the bankers buy these bills? The bankers buy the bills from persons who have sold goods abroad and have drawn bills of exchange upon these foreign purchasers The bankers purchase the bills from these exporters and they sell the bills to the importers who pay their foreign creditors with these bills

Bills drawn on persons in London, and payable in London are called *paper (bills) on London* Similarly we have *paper on New York, or on Paris*

† *The bill on London*

The great mass of bills is to-day drawn on London in pounds sterling, (exchange payable in London in pounds sterling is called *sterling exchange*) This is due chiefly to the immense volume of British trade, the stability of the British currency and to the fact that the seller of a bill on London can almost invariably count upon finding a buyer on advantageous terms

The Rate of Exchange

We have seen that international payments are very largely made through the cancellation of credits and debits and only a small amount of metallic money is needed for clearing the uncancelled balance remaining after the cancellation of credits and debits *The*

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†"Why is it that in the East Indies, those who ship produce to America draw on London not on New York, and why the New Orleans cotton exporter draws on London instead of on St Petersburg for the cotton shipped to Russia A partial cause might be found in the credit granted by London bankers, and also in the greater reputation of the London houses The primary cause is to be found in the stupendous and never ceasing exports of England" (Goschen—Theory of the Foreign Exchanges)

"*A draft on London which is the real currency of international commerce and finance*, because money in the real sense of the word, gold or its equivalent, is only to be had, always and without question and to any amount in London London's money is not only more genuine that is, more undoubtedly convertible than that of any other centre, but is also under normal circumstances both more cheaply and easily produced to suit the convenience of the user (Withers—The Meaning of Money)

Bills on London (but not on any other centre) are immediately and unquestionably convertible into gold Again the vast exports of England create a vast demand for bills on London, and so these bills are always more saleable than other bills and on more advantageous terms So business men of all countries prefer to get their payment by bills on London which have thus become the currency of international commerce———Chinese merchants exporting silk to America and American merchants exporting cotton to Russia, they all like to have their payments through bills on London, which thus becomes the financial centre of the world

In Adam Smith's time London did not possess this position of central importance in the world's trade and finance And London's supremacy in this respect may be challenged perhaps by New York in future, but not yet

large mass of international payments may be supposed to be represented by bills of exchange

The rate of exchange is the rate at which the money of one country can be converted into the money of another country, and the process of converting the money of one country into the money of another country is carried out through the purchase and sale of foreign bills of exchange

The rate of exchange depends chiefly upon the supply of and demand for foreign bills What amount of money would an American importer pay in American money (dollars) to get from an American exporter a bill for £1000 on London depends upon the demand for and the supply of bills on London

The subject of the Rate of Exchange is to be discussed under the three following heads

(a) The par of exchange between two countries and how it is determined *(b) the limits to the fluctuations* in the rate of exchange *(viz the gold points) (c) the fluctuations in the rate of exchange* within these limits *and the causes* bringing about these fluctuations

(a) The Par of Exchange Premium and Discount

The word 'par' means a state of equality

The rate of exchange between two countries is said to be at *mint par* when the rate is such that the money of one country can be converted into its exact specie equivalent in the money of another country [An English pound sterling contains the same amount of pure gold as in 4 866 American dollars, and so when a £1000 bill on London sells in America for exactly 4866 dollars (1000 × 4 866 = 4866) then exchange between England and America is said to be at mint par]

When the total money value of exports from America to England equals the total money value of the imports into America from England, then the supply of bills on London will equal the demand for bills and exchange will be at par

The rate of exchange is very rarely at mint par

When a bill for £1000 on London sells in America for less than £1000 or less than 4866 dollars (*i e* when each pound of bill sells for less than 4 866 dollars in American money) then sterling exchange on London is said to be below *par* or *at a discount*

When a bill for £1000 on London sells in America for more than £1000 (*i e* for more than 4 866 dollars in America) sterling exchange, (*i e* exchange calling for pounds sterling) on London is said to be *above par* or *at a premium*

(b) **Limits to fluctuations in the rates of exchange**

When the supply of bills exceeds the demand, the rate of exchange falls and when the demand for bills exceeds the supply the rate of exchange rises

The *rise and fall in the rate of exchange are ordinarily within very narrow limits fixed by the cost of transmitting bullion*

The only object of using paper (bills of exchange etc) is to save the cost of transporting coin from one country to another and so variations in the rate of exchange (price of paper) cannot exceed the cost of transmitting coin because then it would be cheaper to transmit coin than to use paper

The two limits to fluctuations in the rate of exchange are thus —

*Specie points or gold points

(*a*) Par value plus the cost of transmitting specie (*maximum rate*)

(*b*) Par value minus the cost of transmitting specie, (minimum rate) *The specie points or gold points are the limits in the rate of exchange at which gold flows from country to country*

The rate of exchange does not rise ordinarily beyond the maximum rate given above because persons, who have to remit money abroad, will find it cheaper to send specie and incur the cost of sending specie rather than buy bills at a rate exceeding the par value of exchange by the cost of sending specie

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* When the rate of exchange is at the upper gold point and is equal to the par value plus the cost of transmitting bullion gold is exported and this point is called the *upper specie* or *gold export point*

When the rate of exchange is at the lower limit and equals the par value minus the cost of transmitting bullion gold is imported and this point is called the *lower specie point* or the *gold import point*

The cost of transmitting specie is a variable one, varying with the scale on which specie is transmitted and varying with changes in freight and insurance rates And so the limits to the fluctuations in the rate of exchange, are not also absolutely rigid but are variable limits changing with variations in the cost of carriage

The specie points are not rigid but variable

Similarly the rate of exchange does not ordinarily fall below the par value of exchange minus the cost of transmitting the specie This is because exporters and other persons who have money owing to them from abroad will find it cheaper to call for specie from their debtors abroad rather than sell their bills at a rate which falls below the par of exchange by more than the cost of importing specie

When do the rates of exchange pass beyond the specie points?

Ordinarily the rates of exchange fluctuate between the specie points Under certain circumstances, however, the rates of exchange can rise above or can fall below the upper and the lower specie points determined by the cost of carrying bullion

(*a*) The rate of exchange does not rise above the specie point so long as people find no difficulty in getting gold bullion for making payments to foreign countries *If there is a difficulty in getting gold bullion* for export (because the banks are not willing to give gold or because the country has been drained of its gold by an adverse balance of trade or because the country has got a currency consisting largely of silver etc) *then the rate of exchange will rise above the upper specie point*

(*b*) The rate of exchange does not fall below the specie point as long as bullion is freely imported into a country

Bills in a country on foreign countries will fall below specie point when there is a sudden demand for cash in that country, when there is a monetary stringency the holders of bills will sell these bills at a rate lower than the specie point to get the cash which they urgently want

Goschen notes that in 1861, at the time of the American Civil War, exchange in America on England fell far below specie point On account of the war the American holders of bills on London were in a panic, they would not wait and they had to sell their bills at a sacrifice—and so exchange fell far below specie point

(c) Fluctuations in the rate of exchange

Within the limits of the specie points, the rate of exchange (the price of sight bills) *varies as the demand for and the supply of bills*

When the supply of bills in a country on a foreign country exceeds the demand for such bills, the rate of exchange falls *below par* (it is said to be at a *discount*)

When America exports more commodities to England than she imports from England, in America the supply of bills on London being thus greater than the demand for such bills, the rate of sterling exchange (i e exchange calling for pounds sterling in London) will fall below par Any other cause increasing the credits of America will tend to bring about a fall in exchange

And when the demand for bills exceeds the supply, the rate of exchange rises *above par*, (it is said to be *at a premium*) When the total value of imports into America from England exceeds the total value of the American exports to England, then the demand for bills on England will exceed the supply of bills on England, and so the rate of exchange will rise above par

Interest rates

The rate of exchange is influenced by the interest rates in a country and abroad and by the many forces affecting interest rates

A rise in the rate of exchange will be moderated to some extent if the interest rate in America is higher than the interest rate in England The higher interest rate in America will induce the English creditors to lend their money in America to earn the higher rate of interest, and so the demand in America for foreign exchange on London will be diminished, and thus the rate of exchange will be moderated on London

In actual fact the rates of foreign exchanges are determined not by dealings between two countries but between a country and all the countries, with which it has dealings

† The interpretation of the foreign exchanges—favourable and unfavourable exchange

Also the state of the foreign exchanges depends (not upon exports and imports of commodities only but) *on the total credits and debts of a country Fluctuations in the rate of exchange are at once the necessary results and the certain index of the indebtedness of the different countries*

(a) When the price of paper payable abroad is quoted above

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† The rates of exchange form a valuable index of international indebtedness, and properly interpreted give extremely useful indications of rates of interest, credit and currency conditions in different countries

Goschen in his masterly treatise refers to "the *Foreign Exchanges in their peculiarly valuable character as an unerring mercantile and*

par in a country (i e, when a given amount of money metal paid in the home country purchases the right of receiving a smaller amount of money metal in the foreign country) then the *rate of exchange is said to be 'unfavourable' to the country*

The rate is regarded by business men as unfavourable because such a rate leads to the exportation of bullion from the country (and higher interest rates) When paper payable abroad (*i e* paper drawn on a foreign country) is quoted above par, it means that the demand for paper drawn on the foreign country is greater than the supply, and this happens when the country has imported more from the foreign country than it has exported and so the country is indebted to the foreign country, and the country will have to export bullion to pay for the excess imports

(Such a rate is really *unfavourable only to the importers* in the country, because they have to purchase bills on the foreign country at the higher rate for making their payments, but it is *favourable to the exporters,* as they are able to sell their bills to the importers at a higher rate and thus the exporters make increased profits)

(*b*) The *rate of exchange is said to be 'favourable'* to a country *when the price of paper payable abroad is quoted below par within the country* (*i e* when a given amount of money metal offered in the home country will purchase the right to receive a larger amount of money metal in the foreign country)

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monetary barometer" The fluctuations in Foreign Exchanges, if properly interpreted, clearly indicate the state of the commercial atmosphere, and also suggest the course by which danger can be avoided and panic moderated (Theory of the Foreign Exchanges)

"As an index of the general position of trade, the value of short bills is the more important whereas the rates given for long paper point mainly to the rate of interest and partially to the state of credit"

The two terms 'favourable exchange' (with importation of gold) and 'unfavourable exchange' (with exportation of gold) are now used accurately enough from the monetary or banking point of view—but not from the point of view of the country at large An importation of bullion (favourable exchange) is favourable to businessmen and bankers for it tends to lower the rate of interest in the money market, and an exportation of bullion (unfavourable exchange) is unfavourable to businessmen and bankers for it tends to raise the rate of interest, the old mercantilist idea that an importation of bullion is favourable and an exportation of bullion is unfavourable to the country as a whole—this idea is now entirely exploded and is no longer believed in by modern economic writers

Such a rate of exchange is regarded by business men as favourable because it leads to an importation of bullion Such a rate results when the demand for paper drawn on the foreign country is less than the supply, *i e* when the country has imported less than it has exported, and the country will import bullion in exchange for its excess exports

(A 'favourable' rate of exchange is favourable only to the importers but it is unfavourable to the exporters)

Economists have criticised the use of these expressions unfavourable and favourable exchange,on the ground that business men using these expressions seem to be under the influence of the mercantilist fallacy that an export of bullion is always injurious to a country and that an import of bullion is always beneficial to a country

How the exchanges automatically tend to correct themselves ?

A rise in the rate of exchange on account of a deficiency in the supply of bills, tends to correct itself by increasing the profits of the exporters, stimulating exports and thus bringing about an increase in the supply of bills

Similarly a fall in the rate of exchange on account of a diminished demand for bills, tends to correct itself by increasing the profits of the importers, stimulating imports, and thus bringing about an increased demand for bills.

The correctives of the Exchanges

An interpretation of the Foreign Exchanges naturally leads to the question of their correction when necessary and desirable Automatic correction takes time, is not always possible, so other steps also become necessary Again to quote Goschen "At all events it must be borne in mind that that which is really to be corrected is not the actual position of the exchanges but that state of things which has brought it about "

(i) When the disturbance in exchange is due to depreciation of the currency, the reform of the depreciated currency is the proper corrective

(ii) When the unfavourable situation in exchange is caused by some disturbance in the balance of trade, or by rise or fall in the rate of interest—the correction lies in the regulation of the rate of discount in the money market

In England this is done by the Bank of England manipulating its bank rate of discount (See page 120)

The Paper Exchanges

How are we to determine the rate of exchange between England and a country with a depreciated paper currency? The answer is simple Exchange payable in a depreciated paper currency must suffer a depreciation equal to that of the paper money itself

And as the depreciation of paper may be considerable, the fluctuations in the rate of exchange as regards such a country may be very large and appear to have no limit at all

The Silver Exchanges

Metallic money also may be depreciated During the latter part of the 19th century, the value of the silver money fell considerably in comparison with gold The result was that claims by gold countries to be paid in silver by silver using countries got depreciated in value with the depreciation of silver, and claims by silver countries (e g China) to be paid in terms of gold money by gold countries increased in value with the appreciation of gold

Now the situation has changed, and silver has risen greatly in value

The Indian Exchanges

Since the closing of the Mints, the rupee is a token coin with a coin value higher than its intrinsic value

The coin value (or legal value) of a rupee is 1*s*-4*d* (*i e* $\frac{1}{15}$ of £1) The artificial par of exchange between England and India is Re 1 = 1*s*-4

Ordinarily India exports more than she imports, there is an excess of exports even deducting what she must pay as Home Charges to England and so the rate of exchange for bills on India is ordinarily above par (above 1*s*-4*d* for the rupee) When exports fall off on account of a famine in India or other causes, then the rate of exchange falls, and if the exports fall off greatly, it may fall below par

Ordinarily, the gold import point in India is 1*s* – 4$\frac{1}{8}$*d*

The Secretary of State for India sells in England about £16,000,000 (or more) worth of bills on India annually to get payment for his Home Charges, and by diminishing and when necessary by stopping the sale of his Council Bills he can do much to keep up the price of bills (or in other words the rate of exchange)

The War and Foreign Exchanges

The present world war has been specially rich and fruitful in matters relating to foreign exchange, and economic theory on this subject has stood the test remarkably well

Different courses of action are open to the banks for the protection of the gold reserve

The best course is to raise the bank rate Raising the bank rate has

(a) an immediate effect

(b) an ultimate effect

(a) *Immediately it checks the drain by making the discount of bills costly*—maturing bills instead of being discounted and thus drawing gold out of the country are retained in the country on account of the increased cost of discounting *And the raising of the bank rate attracts gold from foreign countries* because a country with a high bank rate is a profitable market for investment specially of short loans

(b) *Ultimately the high bank rate tends to remove the cause of the export of bullion* The cause of the export of bullion is that the imports exceed the exports

Now a high bank rate discourages borrowing on the part of merchants and manufacturers on account of the increased cost of borrowing and so when the bank rate is high there is less money circulating within the country and therefore the prices within the country fall When the prices in a country are low, foreign countries will buy more in that country and will sell less to that country In this way the fall in prices will increase its exports, and will diminish its imports,—and thus the excess of imports over exports, which was the cause of exportation of gold bullion will disappear

A rise in the rate brings about a depreciation of commercial paper and of stock exchange securities within a country, and leads to large purchases of this paper and these securities by foreign bankers and capitalists and this makes the country the creditor of foreign countries to the extent of these purchases, and this helps to remove the indebtedness of the country which is the cause of the exportation of bullion

Protection

Restrictions on international trade have been imposed by nations from very early times at different times and places These have been imposed with different objects in view

In modern times many nations regulate international commerce with the object of weakening foreign competition with domestic industries by such regulations and protecting and developing in that way domestic industries Such a policy is called the *policy of protection* and the theory underlying it is known as the *doctrine of*

protection Generally protection seeks to encourage domestic industries against foreign competition by taxing imported foreign commodities which compete with domestic industries These taxes are called *protective duties* and collectively they form a *'protective tariff'* (Protectionists sometimes protect domestic industries not only by taxing competing foreign commodities but also in some cases by granting *bounties* to domestic producers)

Free trade

As opposed to the policy of protection we have the policy of free trade *A nation is said to have free trade when it does not impose any restrictions upon its international trade with the object of protecting its industries against foreign competition* A free trade country may impose taxes upon foreign imports for the purpose of getting a revenue, but such taxes are not intended to protect domestic industries (Taxes imposed upon foreign commodities for revenue purposes are collectively said to form a *'tariff for revenue'* as opposed to a *'protective tariff'*)

Arguments for protection

I Some arguments in favour of protection

1) Economic arguments

Some protectionists declare that *international trade is economic warfare between nations* and that free trade between nations which are industrially strong and nations which are economically undeveloped will lead to the enrichment of the stronger nation and to the destruction of the weak, So protection is necessary in the interest of the weaker nations

(This argument is not a valid one because no nation is inferior to other nations in all branches of production)

Some popular arguments in favour of protection are the following —

(2) The home market argument

Foreign markets are distant and precarious, they may be cut off by wars or by changes in the tariff policy of foreign governments while the home-market is steadier, more secure and near at hand It is therefore desirable that the steady home-market should be secured to domestic producers by a policy of protection

Some protectionists maintain that free-trade makes the distribution of labour and capital within a country subject to the control of the

foreign country to which it exports its goods The foreign country will by protection and other means develop within its territories those industries which are conducive to the physical, mental and moral welfare of the nation, leaving to the other country the less desirable industries

The home-market argument is one of the earliest protectionist arguments and it is still in use in the United States

(3) The employment argument (or make work argument)

Protection creates new domestic industries in a country by shutting out foreign competition and thus provides more employment for labour and capital

(This argument is not a strong one When there are less imports on account of protection there will be also less exports The exporting industries will thus suffer and there will be less employment in them

4) The wages argument in the United States

The protectionist argument most popular among the labouring classes in the United States for the last half century is that *protection raises wages* or keeps them high High protective duties on foreign goods shut out the cheap foreign commodities made by cheap foreign labour, and make possible high prices for domestic goods and thus enable business men to pay high wages to labour

(This argument is also not a valid one Wages in the United States are high even in those industries which are not protected, the *high wages are due mainly to the high productivity of labour and abundant natural resources*

Of course in some of the protected industries, wages are kept up artificially by protection, but free traders maintain that under free trade labourers engaged in these industries will be able to find as well paid employment in other industries more suited to the country)

(5) The equalization of cost argument

This was the latest form of the protectionist argument in America before the present war

The protectionists declare that the American labourer receives higher wages, and so the cost of production for commodities in America is higher than in Europe, and to protect American labour and industry, taxes should be levied on foreign commodities so as to equalise domestic and foreign costs

(Of course this argument has some good points

But how to calculate costs? Again costs may be different in different foreign countries Again if cost "plus a reasonable profit" for the business man is asked for—that would mean a high and injurious form of protection)

The arguments in favour of protection, which we have already discussed, do not make out a good case for protection and do not justify its introduction There are other arguments in favour of protection some of which possess considerable elements of strength

(6) The infant industry argument for India and other backward countries

The strongest economic argument in favour of protection is the infant industry argument

Infant industries (including unborn infants) should be protected during their infancy from foreign competition and thus helped to grow up to maturity

A country which wants to start a new industry has to meet certain *initial difficulties* regarding labour, capital and organization it has to train the labour force in that industry and it will have to attract capital and organization to the new industry started and in overcoming these initial difficulties the country will be helped by a policy of *temporary protection* for the infant industry When these infant industries have grown up and are in a position to compete successfully with foreign industries as regards the prices and qualities of goods then only protection should be withdrawn and free trade should be established *Protection is used as a temporary expedient and the ultimate goal is free trade*

The temporary loss from protection is compensated by the ultimate gain in the shape of the establishment of new industries (and according to List, increase of productive power)

When the infant industry has grown to maturity, *then competition between domestic producers will lower the prices for consumers*

The *theoretical validity* of this argument has been admitted by almost all economists Its truth was recognised by J S Mill, one of the staunchest and sanest advocates of free trade in his classical passage on this subject.

[This argument was first advanced in United States in the early part of the nineteenth century and it was carried from the United

States to Germany by Friedrich List, its best known advocate. Germany and the United States have now large and flourishing manufactures and so they no longer rely on the infant industry argument—they have now other arguments for protection. For India, with her undeveloped manufactures, this argument is largely used.]

[List and other advocates of nurturing protection hold that protective duties for this purpose should be (a) moderate, (b) on manufactured commodities only and not on agricultural commodities or raw materials and (c) should be temporary. The duties should be moderate because an industry really suited to the country would not require heavy protection. And he holds that in the manufacturing industries only there is a chance of bringing about the establishment of new industries by a judicious policy of temporary protection.

Taussig points out that there are instances in which new industries have been successfully established in a country not only by moderate duties but also by heavy protective duties and an illustration is supplied by the silk manufacture in the United States.

The infant industry argument takes (a) a special, (b) a more general form.

(a) † *In its special form*, it advocates temporary protection for specially selected industries which are specially suited to a country because of the existence there of an abundant supply of raw materials or because of the aptitudes or necessities of the people.

(b) List has advocated however *a more general form* ‡ *of the infant industry argument*. According to him countries pass through *definite stages* in the history of their industrial development and protection is necessary to enable a country to pass from an agricultural stage to the manufacturing stage.

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† "The only case in which, on mere principles of political economy, protecting duties can be defensible, is when they are imposed *temporarily* (specially in a young and rising nation) *in hopes of naturalizing a foreign industry, in itself perfectly suitable to the circumstances of the country*. But the protection should be confined to cases in which there is good ground of assurance that the industry which it fosters will after a time be able to dispense with it." (Mill—Principles.)

‡ "*Finally, history teaches us how nations may and must modify their systems according to the measure of their own progress: in the first stage, adopting free trade* with more advanced nations as a means of raising themselves from a state of barbarism, and of making advances in agriculture; *in the second stage*, promoting the growth of manufactures, fisheries, navigation, and foreign trade by means of *commercial restrictions*; and *in the last stage* after reaching the highest degree of wealth and power by gradually reverting to the principle of *free trade* and of unrestricted competition in the home as well as foreign

During this stage of transition from the agricultural to the agriculture and manufacturing stage, protection is necessary for almost all the industries in the country. When the country has fully attained a great degree of industrial development, then protection should be removed and a policy of free trade should be established.

In the agricultural stage a country benefits by having free trade, and also it requires free trade when its manufactures have grown up. A policy of temporary protection is wanted only during the stage of transition to start new industries in the country and to protect them from being overwhelmed in their infant stage by unrestricted competition of the developed industries of foreign countries.

A criticism of the infant industry argument by free traders pointing out its *practical difficulties* is given later on.

(7) **The argument from vested interests.** [Protection is also advocated for industries which are no longer infants on the ground that foreign competition will ruin these industries. This is an argument for the protection of the vested interests of capital and labour. Fixed capital is immobile and also to some extent many kinds of labour, and the loss due to protection is to be borne to avoid a great loss to the capital and labour engaged in these industries.

(The argument applies only to exceptional cases and under exceptional circumstances and it should not be used as a general protectionist argument by any progressive community.)

This may be a consideration not for *suddenly* abandoning protection, but it is no argument for the introduction of protection.

(8) ‡ **Protection for agriculture in Germany.**

In Germany, France and other European countries before the present war, protection was demanded and obtained for agriculture against imported agricultural products from the United States etc.

German protectionism was partly economic, partly political and social. "The maintenance of a capable German agriculture means the maintenance of the German people now and for the future." (See page 128.)

The chief economic argument was that German exports of manufactures to foreign countries in return for imports of food and raw materials could not continue for ever; sooner or later the foreign countries with increasing population and manufactures would require all their own food and raw materials. Therefore Germany must depend on herself and must protect German agriculture.

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markets, that so their agriculturists, manufacturers and merchants may be preserved from indolence and stimulated to retain the supremacy which they have acquired." (List—The National System of Political Economy, Book I Chap X.)

‡ For the "Agrarund Industrie Staat" controversy in Germany see Taussig (Principles) and Ashley (Modern Tariff History).

(9) The dumping argument.

Dumped goods disturb the industries of the country into which they are dumped and such a country would under certain circumstances be justified in preventing its industries from being disturbed by the unfair competition of dumped goods.

(10) *Conservation of natural resources.* This is often to the ultimate gain of the country, and reasonable protection for this purpose is a reasonable policy.

(11) Protectionists have held that *customs duties on foreign goods are the best kind of taxes* as they are paid by foreigners and these duties at the same time protect domestic industries from foreign competition.

(Customs duties which are high enough to shut off foreign competition will protect domestic industries but there will be no revenue for the Government as foreign commodities will not be coming in. So we see that *effective protection and large revenue for the Government do not go together.*

Also it must be remembered *that customs duties are not always paid by the foreigners,* they are very generally shifted by the foreigners wholly or partly to the shoulders of the domestic consumers.)

II Non-Economic arguments in favour of protection

A country may not find protection necessary from an economic standpoint. Protection may even injure the economic interests of the country,† but the policy of protection should be adopted if political gains (*national strength, national self sufficiency in war time etc.*) and other non economic gains (*social development and progress*) from such a policy outweigh the economic disadvantages of protection.

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† The classical passage on this point is that of Adam Smith and it is very frequently quoted.

Referring to the political importance of the Navigation Act for the navy and national defence of England, Adam Smith remarks "*As defence, however, is of much more importance than opulence,* the act of navigation is, perhaps, the wisest of all the commercial regulations of England." (The Wealth of Nations—Book IV, Chapter III)

(1) An argument which has found some measure of support is this—*protection promotes nationalism* Protection against foreign competition binds the different parts of a country by common economic interests and thus strengthens national feeling among the people

(This argument is not a decisive one, nationalism can be promoted in other and by better ways than by protection)

(2) A nation should be independent of other nations as regards the supplies of military materials e g, cannons, rifles, ammunition, etc, for foreign supplies may be absolutely cut off or largely interrupted by wars and so industries for the manufacture of war materials should be established and maintained by protection if required

Protection necessary for war industries

(3) **Diversification of industry argument.** Diversification of industries to be brought about by protection has been advocated on (a) *Social grounds* *Variety of occupations makes possible the all-round development of the physical and mental faculties of a people*, it brings about a rich, intense, organized and progressive social life

(b) *Political grounds* *Diversification is also necessary for national industrial self-sufficiency during times of war* (a) A nation weak in agriculture, and dependent upon food supplies from foreign countries (b) Or a nation having one or two chief industries, and depending upon foreign markets for the sale of the products—these nations if they are cut off by wars from foreign countries will suffer terribly The dependence upon foreign countries should be reduced by diversification of industries within the country

(Protection for agriculture has been advocated in England on the ground that it would make England less dependent upon foreign supplies of food In Germany before the war, protection to agriculture was urged by one group of protectionists, partly on the same ground and partly because it was thought that an agricultural population would be better military and social material than a manufacturing population

The last European war has shown that the industries indispensable for the safety of the country include not only weapons and production of food, but also many other industries which help directly or indirectly to feed, clothe, equip and keep in a state of general efficiency millions of men in arms Almost every occupation helps to some extent in national defence, a very extended scheme of protection has thus become necessary for countries which will be deprived of foreign supplies by a great war

The strength of this argument for protection comes from the present state of international relations)

(3) Professor Patten argues that protection helps to promote a higher civilisation specially in dynamic (i e progressive) societies like the United States with extensive natural resources

Protection is thus much more than a mere economic expedient It is an agency and a valuable agency for the development of a higher civilisation Prof Patten is however too subtle for the average man, and his argument is taken as a form of the wages argument, (See the equalization of cost argument)

Arguments of advocates of free trade

Among economists, especially in England and America, free traders are a powerful party, though the doctrine has lost a considerable amount of its hold upon practical politicians and upon the mass of the people

The arguments which are advanced in favour of free trade are not all equally strong indeed some of them are almost as foolish as the weakest arguments in the armoury of the cruder protectionists

We begin with the refutation of these weak and unscientific arguments and then we shall consider the really strong arguments in favour of free trade

1 Some unsatisfactory Free Trade arguments

Protection violates natural rights

(a) There are some free traders who declare that protective duties violate the natural right of a man to buy and sell where he pleases and so free trade should be established

Now this argument from natural rights is absolutely untenable because no such natural rights exist The question is to whether a country is to follow free trade or protection is not to be decided by a reference to imaginary natural rights but from the standpoint of the general welfare of the whole country

Protection is socialistic

(b) Certain uncritical free traders maintain that free trade should be followed and protection avoided because protection means socialism The word socialism should not however frighten us, we should be ruled by facts and not by words When protectionism is really advantageous to a community it should be adopted without the least measure of hesitation

II The real case for free trade

The *really strong arguments* for free trade are those based upon (a) *that free trade confers positive advantages on a country* (b) *that protection does not in actual fact realise the beneficial objects* which it attempts to accomplish, or that these objects may be realised by means other than protection (c) *that protection injures national interests* in certain respects and so the adoption of free trade is the only alternative

(a) The positive advantages resulting from free trade

The general argument in favour of free trade follows from the principle of division of labour, free trade enables each country to devote its capital and labour to those industries for which it has the greatest natural advantages and the best aptitudes and so each nation attains a maximum industrial efficiency and the industrial efficiency of the world as a whole is thus greatly increased These nations trading with one another all benefit one another by their mutual exchanges though in an unequal degree

(b) Protection does not realise its aims

Protection does not protect labour

(1) The idea that protection protects labour and raises wages has been subjected to examination and has been refuted High wages are due generally to high efficiency of labour and not to protection If domestic labour is to be really protected, it would be better to prevent the importation of labour rather than the importation of commodities

(2) The view that protection secures at the same time large revenue for the government and also protection for domestic industries is not well founded

(3) Criticism of the infant industry argument

Free traders admit that *theoretically* the infant industry argument is a strong one, advocating as it does temporary loss in the shape of increased prices for consumers etc for the sake of a larger ultimate gain in the shape of the establishment of new industries in the country, but they point out the following *practical objections* against the infant industry argument

(1) These infant industries never grow up, they always remain infants When some of the industries by protection have actually

grown up and become strong enough to fight against foreign competition even then they would say that they have not grown up and they would clamour for the continuance of protection It is difficult to withdraw protection once given and *temporary protection tends to become more or less permanent*

(ii) Temporary protection under the infant industry argument is properly given when it is given to *really suitable industries* and given *for a fixed period* (and not indefinitely) and when the ultimate gain would be large enough to outweigh the temporary loss due to protection

In actual practice, however all these considerations are not carefully borne in mind by a Government granting protection and so the losses from protection are often greater than the gains

(c) **Protection produces certain serious evils** and this makes the adoption of free trade necessary and desirable

The evils of protection are the following —

1 Economic evils

Production made less efficient by protection

(i) Protection in a country diverts labour and capital from those industries which are naturally more productive to the artificially protected industries It thus reduces the industrial efficiency of the nation and makes it less productive than it would be under a system of free trade

(ii) Again if protective duties are levied upon the raw materials for manufactures, upon machinery and other equipment for industrial enterprises, then the home industries will be heavily handicapped in their competition with foreign industries

Protection fosters monopolies and trusts

(iii) It has been ascertained that protection fosters the growth of monopolies and trusts by shutting out foreign competition *Indeed it has been said that the protective tariff is the mother of trusts* At least this much is true that if there had been no protection then international competition would have been a very effective instrument to use against the trust and to reduce its powers for evil

(iv) Protection by weakening or removing altogether foreign competition slackens the spirit of industrial progress among home producers, tends to make them less energetic and enterprising. This is a great danger specially in a conservative country like India where the enterprisers are generally timid and unenterprising and unwilling to introduce quickly modern improvements in methods of production and business organization.

Business enterprise and industrial progress slackened

(v) The import duties, under a system of protection, raise the price of imported commodities and also the prices of corresponding commodities manufactured within the country, and the loss to consumers in the shape of increased prices is much greater than the revenue realized by the government.

Consumers suffer

(This is an important consideration in India where millions and millions of consumers are in wretched poverty and on the brink of starvation.)

(vi) *From the standpoint of distribution* protection is unjust. It enriches producers who are rich at the expense of consumers, a great majority of whom are poor.

(This is also an important consideration in India.)

(vii) *From the commercial point of view*, protection is undesirable. A policy of protection brings about a reduction in imports and this will bring about a reduction in exports so the export industries will suffer.

Labour and capital engaged in export industries will be injured by the reduction of employment.

II. Non Economic Evils

1. Actual experience in the United States has shown that protection endangers the political morality of the people. Large industries controlling enormous amounts of capital will bribe legislators to retain the existing amount of protection or to increase it.

2. Tariff wars between nations embitter international relations and have been known to lead to wars.

Every country has its own problems of international trade

Protection is necessary in India for some industries but only with sufficient precautions and suitable instruments For India, the large loss to consumers the question as regards the distribution of wealth the conservatism of the Indian people, the danger of political and commercial immorality have to be weighed against any possible advantages from protection The Indian government is fairly efficient but it is bureaucratic not responsible to Indian public opinion not sufficiently businesslike and it is controlled by the British democracy at home—and as at present constituted, this government is not the fittest instrument for introducing protection specially when the question is between Indian and English industries

Dumping Retaliation Reciprocity

For dumping and the different kinds of dumping see Part I Book Fourth Chapter III page 275

Under modern conditions of industry, producers often find it desirable to sell the surplus stock in foreign countries at excessively low prices thus keeping up prices in the domestic market where it is their chief market

The advantages from dumped goods

Some writers maintain that the foreign country in which the goods are dumped is benefited than otherwise

The consumer of the country get dumped articles at cheap prices and manufacturer will get their raw materials cheap if these are dumped into the country

The continental countries which dumped bounty fed sugar into England at extremely low rates enabled English consumers to get their sugar for almost next to nothing

When does dumping injure? Protection against dumping

Under other circumstances dumping is injurious to the country to which the dumped goods are sent Russia wants to develop her iron industries, she wants to make her own rails And the dumping of cheap German rails into Russia will be prevented by Russia in the interest of her own industry

Protection against dumping is thus desirable under certain circumstances This is an important protectionist argument

The *practical difficulties* in connection with the prevention of dumping are however considerable

Reciprocity or Fair Trade

This is to be distinguished from Free Trade According to the strict principles of Free Trade, a country should allow the imports from a foreign country to come in freely even if the foreign country levies protective duties against that country

The advocates of Fair Trade (as opposed to Free Trade) maintain that a policy of Free Trade should be adopted in the trade with Free Trade countries and that against protectionist countries a protectionist policy should be followed. There should be reciprocity in the matter of trade. (In answer to this, free traders point out that if a free trade country in spite of protective taxes levied by other nations on her goods can get the goods of other country in exchange for her own goods at less cost than she could make goods like them for herself, it was in her interest to do so.)

Retaliation

The advocates of Retaliation recognise the advantages of Free Trade. They look upon Free Trade as the ultimate goal and they support retaliation as a temporary policy to compel foreign nations to [illegible] taxes on imports from the home country and thus bring about Free Trade.

As soon as the foreign countries have been brought [illegible] retaliation would be dropped and the policy of Free Trade [illegible].

Retaliation has been supported by † Adam Smith and [illegible] is powerfully supported by some modern economists including Gustav Schmoller.

Objections against the policy of Retaliation

(1) Opponents of retaliation point out that [illegible] measures of retaliation have generally failed to produce the desired effect.

(2) Retaliation may provoke counter retaliation and thus lead to endless economic warfare.

(3) It is difficult to adopt measures [illegible] the trade of a foreign country in such a way as to avoid corresponding injury to the home country. Restrictions on such foreign imports [illegible] will seriously injure the foreign countries will also generally be felt [illegible] by the purchasers of these imports in the home country.

It is to be carefully remembered that *retaliation is to be justified only from the point of view of free trade* [illegible] successful only if it succeeds in bringing about free trade [illegible] completely thrown away.

Tariff Reform movement in the United Kingdom

The English tariff of duties at present is largely a free trade tariff. England follows a policy of Free Trade towards foreign countries. India also follows a Free Trade system but the British colonies are attached to a strict policy of protection.

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† "*There may be good policy in retaliations of this kind* when there is a probability that they will procure the repeal of the high duties or prohibitions complained of." Adam Smith goes on the point out that to judge whether such retaliations are likely to produce such an effect does not, perhaps, belong so much to the science of a legislator as to the skill of "that insidious and crafty animal vulgarly called a statesman or politician."—(The Wealth of Nations, Book iv)

In the United Kingdom, even before the last war there was an important movement for the reform of the tariff

Tariff Reform is to be in the direction of protection against foreign countries, the United Kingdom continuing largely to follow its Free Trade policy towards the colonies and other countries within the Empire

Imperial preference and the reform of the Tariff

The tariff reform movement wants to encourage trade within the empire, trade between the mother country and the colonies and the dependencies, and it wants to protect the empire from the competition of foreign countries by levying higher duties upon foreign products than upon products produced within the empire

(1) England is to levy lower duties upon food stuffs (wheat, meat etc) and raw materials coming from the colonies and to levy higher duties upon foreign food-stuffs and raw materials

(2) For this preference shown to their food-stuffs and raw materials, the colonies are to grant preference to the manufactures of the mother country by taxing them at a lower rate than foreign manufactures The inclusion of India within the scheme of preference has been advocated

I - Advantages expected from the reform of the tariff and the establishment of imperial preference

The advocates of imperial preference expect the following advantages

(1) The closer economic connection brought about by their commercial union would strengthen the political ties between the colonies and the mother country and it would make for the greater solidarity of the empire This is a very important *political advantage* (2) The mother country at present depends to a large extent for her *food-supply* upon imports from the United States and other foreign countries , and these imports may be cut off by wars in which these countries may be engaged even if England is not involved This terrible danger from the political stand-point may be avoided by a greater dependence upon colonial food and the encouragement of food production in the colonies by a policy of preference Food production in the United Kingdom also may be encouraged

As regards manufacturing industries Britain is not likely to gain much because the colonial market for manufactures is comparatively small and the colonies are not likely to give any very substantial and effective preference.

The colonies would gain by the preference shown to their raw materials and food stuffs.

The object of the advocates of this policy is that the British Empire should be economically independent of the rest of the world and also should secure the political advantages which would result from such economic independence.

Criticism of the policy of Imperial Preference

(1) The United Kingdom (i.e. Great Britain and Ireland) will have to make great economic sacrifices under such a policy.

(a) *Imports*

Higher taxes on foreign [illegible] raw materials imported into Britain would increase the cost of British [illegible] manufactures and would curtail their sale in foreign markets. Higher taxes on foreign food stuffs than on colonial food stuffs would increase the price of food for the British people.

(b) *Exports*

Foreign countries also [illegible] by increasing protection against British products [illegible] to them.

And for these sacrifices [illegible] able to offer to Britain an [illegible]

(2) So the question turns [illegible] political advantages. Some critics deny the real and [illegible] character of these political advantages. Prof. Marshall [illegible] declared "As it is, the schemes appear to me likely to breed more of disappointment and friction between England and her colonies than of good will and the true spirit of Imperial unity."

Conclusion

If the political advantages are real and substantial, if they outweigh the economic sacrifices, then a policy of preference should be adopted, and it is on this ground that a policy of preference is advocated by the sanest advocates of imperial preference.

The great war in which the British people was engaged recently supported by the loyalty and enthusiasm of the colonies has increased in some quarters the desire for closer economic and political connection between the mother country and the colonies and the wish to shut out the enemy countries from economic exploitation of the British empire even after the conclusion of peace will be a powerful factor in that direction It was maintained in the last year's edition of this book that schemes of imperial preference were in the air and would in all probability be translated into fact at the time of the reconstruction after the war

An experiment in Imperial Preference

And already an experiment in Imperial Preference has been started—India is the subject of the experiment

(1) Indian tea is to get a preference of 2d per lb over foreign tea in the English market, and (2) India is to give preference to Britain and the colonies of the British Empire by taxing hide exports to these countries at a rate of 5 p c while taxing hide exports to foreign countries at a rate of 15 p c (The export taxes on hides to a minor extent may protect the Indian tanning industry)

† The War and Protectionism

The war has given a great stimulus at least for the time to schemes of preference and protection The New Protectionism of the war seeks to impose the war map of the world with its divisions of belligerents, allies and neutrals upon the older protectionism The Paris Economic Conference declares the determination of the Allies to organize and protect themselves economically against Germany and other enemy powers even after the war, and the enemy powers had then Central Europe (Mitteleuropa) scheme based on the economic and military solidarity of Germany and Austria to begin with, then the Balkans, Turkey etc The ideal is not of protection for a single state but group protection—a group of allies against a group of enemies

Conclusion about Free Trade

An examination of free trade and protectionist arguments leads to these conclusions

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† Hobson—The New Protectionism
Nicholson—War Finance

The problems of international trade are problems partly of national partly of international organization. Free trade progresses during times of peace and protection during times of war between nations.

Between nations which are now in a state of comparative economic equality on economic grounds free trade is the best policy, and protection is unnecessary and even injurious. Even such nations may find protection necessary on political grounds.

At the present moment all nations are not in a state of comparative economic equality. Some nations are backward, others are very much advanced from the industrial point of view. Free Trade between an advanced and a backward nation will benefit the industrially advanced people, and will benefit the world as a whole for the time being at the expense of serious loss to the backward people.

"The essence of free trade is cosmopolitanism, the essence of protection is nationalism."

A nation may rightly follow a protective policy and impose restrictions on international trade—

(1) *To promote national economic interests.* A backward nation is justified in hastening its industrial development by protecting suitable infant industries till they reach maturity.

As Prof. Marshall says "Protection to immature industries is a very great national good."

(2) *To promote national political interests.*

'Defence is better than opulence." National strength and national independence are to be secured even at the sacrifice of economic interests.

(*a*) Protection for industries engaged in making guns, munitions and other war material (*b*) and protection for promoting national industrial self-sufficiency to the required extent in view of interruption of communications with foreign countries during a war—these are justified on this ground.

(*Protection against dumping* is defensible when such protection is necessary to prevent the imported dumped goods from injuring domestic industries by unfair competition. Restrictions on international trade in the shape of *retaliation* are justified if such restrictions are likely to induce the foreign country to lower its import duties on the goods of the country adopting a policy of retaliation.)

Finally it has to be noted that "the great and brilliant achievements of history, both political and economic, are wont to be accomplished at times when economic organization has rested on the same foundations as political power and order" (Gustav Schmoller—The Mercantile System)

Certain general considerations on the subject of Free Trade and Protection

Whether a country follows a policy of free trade or protection is a question to which sometimes too much importance has been attached This question is not after all of vital importance especially in rich and progressive countries inhabited by an intelligent and enterprising people

We see the United States has prospered under protection and so also Germany, and England has prospered under free trade

† *The tariff policy of modern countries has undoubtedly been a minor factor in their industrial life* Industrial prosperity in the United States as well as in England and Germany is principally due to the spread of general and technical education, the development of intelligence and ambition among the people, scientific inventions and discoveries, up-to-date machinery and up-to-date methods of production and business organization—and not due only to free trade or protection A country with an intelligent, enterprising and wealthy population possessing the modern material equipment for production will prosper under free trade and will prosper even in spite of protection

Has the English policy of free trade been followed by other nations?

England gradually changed her policy of protection to one of pure free trade by successive steps in the period from 1815 to 1860

Other European countries did not at first follow the English free trade example, because they thought that the sudden influx of British manufactures would ruin their infant industries which had grown up under the continental system and the exclusion of British manufactures

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† "A last lesson may perhaps, be learned from the consideration of British trade policy during this period that questions of trade policy by themselves have not the primary importance they are generally assumed to have, and that to day, they fall relatively into the background as compared with the great problems of the national organization of production and labour" (Fuchs—The Trade Policy of Great Britain)

Also Taussig—Principles

The specie points or gold points are upward and downward limits in the rate of exchange at which gold flows from country to country, and they are respectively (a) par value plus cost of transmitting bullion (b) par value minus cost of transmitting bullion

A so-called favourable rate of exchange is a rate which leads to the importation of gold and a so-called unfavourable rate is a rate which leads to the exportation of gold

7 Nations have at different times imposed restrictions on international trade with different objects

Protection is defended on economic and also on non-economic grounds On *economic* grounds protection is advocated as increasing employment keeping wages high developing infant industries conserving natural resources, preventing dumping and by protective duties making the foreigner pay while at the same time protecting domestic industries On non-economic grounds, protection is advocated as promoting nationalism securing national industrial self-sufficiency so often found necessary in times of war, and promoting a higher civilization in dynamic societies

The principal arguments in favour of *free trade* attempt to show (a) that free trade confers positive advantage (b) that protection fails to realise its beneficial aims (c) that protection often produces serious evils

(Free traders regard their arguments in favour of free trade as so many arguments against protection and protectionists regard their arguments in favour of protection as so many arguments against free trade)

8 Imperial Preference would benefit the colonies economically by giving preference to colonial products but the United Kingdom will not gain economic benefits in the colonial markets which will compensate her for her economic sacrifices elsewhere Substantial political advantages outweighing the economic sacrifices may make a policy of preference desirable

Questions

1 What are the advantages of international trade, and what are the disadvantages?

2 What do you understand by international values? How are these values determined?

3 Write notes on balance of trade balance of accounts, invisible imports and exports What is a favourable balance

4 What is the rate of exchange what is a par rate of exchange Specie points? Favourable and unfavourable exchange

(b) Indicate the causes of fluctuations in the rate of exchange What are the limits to these fluctuations? Are these limits rigidly fixed?

5 What is the theory of protection Discuss the arguments, economic as well as non-economic usually urged in favour of a protectionist policy in our day (C U 1911)

6 Write a note on the infant industry argument pointing out its theoretical validity, and indicating practical difficulties

marginal productivity (i e, product of the final increment of that factor) to him [1]

The marginal productivity of a factor thus represents the demand price for that factor

Labourers of equal efficiency in a given employment will receive the same rate of wages and the wages of each labourer will tend to equal the marginal product of labour

If wages are above productivity, then the unwillingness of the enterprisers to hire workers will bring wages down When wages are below marginal productivity, then competition between enterprisers to hire more labourers will raise wages up to marginal productivity In this way wages tend to equal the marginal product

Similarly the demand price of the enterpriser for capital tends to equal the marginal productivity of capital And similarly as regards the demand price for land

(*b*) Now let us consider the *supply side* On the supply side the remuneration of each agent of production tends to equal its supply price

The remuneration of an employed factor will thus tend to equal its marginal productivity on one side and its supply price (when it has one) on the other

So far as competition works freely, different enterprisers in the same market will pay the same rate of wages for the same kind of labour, the same rate of interest for the same kind of capital goods, and the same rent for the same kind of land.

[We have assumed that all labourers are of equal efficiency, etc.

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[1] "Employers to get the greatest profit for themselves will try to adopt the most economical combination of the factors of production, and the most economical combination is that in which the marginal productivity of each factor equals its cost In order to realize the maximum profit possible under the circumstances, each employer will endeavour to apportion his land labour and capital so that the marginal product (the increment of product attributable to the marginal unit) of each factor of production will equal its expense to him The amount offered by an employer for a factor of production will depend upon its marginal productivity to him

As a matter of fact all labourers are not of equal efficiency. And to complete the theory of normal distribution we have simply to add that factors in production which possess differential advantages in production tend to be paid in addition to the normal remuneration of factors of marginal efficiency the full value of their differential advantages]

Some remarks on the theory of normal distribution

The following remarks of Prof Chapman in his *Outlines of Economics* are of great interest

(*a*) Chapman remarks that the theory of the payment made for any one agent of production is *in essentials* identical with the theory of payment made for any other agent of production—that is to say, to take one example, the theory of interest paid for capital is in essentials identical with the theory of wages paid for labour Chapman implies that this is so because the remuneration of each agent of production tends to equal the marginal productivity of that agent on one side and its supply price on the other

[It should be remembered however that the qualification "*in essentials*" is an important one Individual characteristics stand out in each theory, because capital and labour are different in nature, though they have striking resemblances to one another in that both are agents or factors of production]

(*b*) *This beautiful and symmetrical theory of normal distribution* as expounded by economists is *not literally true* The generalisations of this theory hold *true only of tendencies* and these tendencies are interfered with in the actual business world by obstacles and economic friction of various kinds [For example, the proportions in which the factors of production are actually combined by different enterprisers are not always adjusted with the nicety and skill which the theory seems to imply]

[*A study of the normal theory of distribution is helpful however and useful in this way* It enables us to understand the tendencies and with the understanding of these tendencies we are making a beginning though only a beginning of an understanding of the social system of distribution]

The marginal productivity theory of distribution—a criticism

(A) *The marginal productivity theory does not furnish a complete ethical justification of the present economic order*

Does the marginal productivity theory of distribution furnish any complete moral justification of the present economic order? The answer is no. *The marginal productivity theory simply describes how the wealth that is produced under present conditions is actually distributed. But it does not prove that the present distribution is just*, that present distribution is as it should be.

This will appear from the following considerations.

(1) Under present conditions distribution is according to productivity. *Whether distribution according to productivity is just—this has been disputed.* Many socialists maintain that distribution according to needs is a higher moral ideal.

(2) *On the ethical side of distribution, we are concerned not so much with the income of a factor of production but with the incomes of persons.* The productivity theory explains how the rent of an acre of land tends to equal the value of its surplus produce. But this does not satisfy us that the landlord who gets that rent is justified in taking it.

(3) Again the efficiency of the labourer which is one of the things determining his productivity often depends largely upon the opportunities which he can get and his opportunities depend upon the social environment—the low efficiency of a labourer which will give him low earnings is not wholly due to the workman himself but may be partly due to society. And society should take steps to increase his efficiency by providing him with ampler opportunities. *Present distribution is not just and is capable of much improvement by proper social provision of better opportunities for the poorer classes.*

(4) *The theory is only a statement of a normal tendency.* The theory states that the labourer tends to get wages equal to the marginal product of labour, the capitalist tends to get interest equal to the marginal product of capital etc.

Actual wages however may differ from normal wages measured by marginal product, the difference being due to custom, and other forms of economic friction, deliberate action and efforts on the part of different classes etc. So even if we accept that marginal productivity is a proper ethical standard *even if we take the view that the wages of labour should equal the marginal productivity of labour even then present distribution is not ethically justified.*

(B) *For the arguments advanced in justification of the present system of distribution*, and showing that it has a sort of rough justice about it, (though not completely justified from the ethical standpoint), see chapter on socialism.

Summary

The National Dividend is distributed among the different factors of production viz, land, labour, capital and organizing. The remuneration

of each factor is determined by its demand and supply; it tends to equal (1) the marginal productivity of the factor on the side of *demand* and (2) the supply price on the side of *supply*. Wages, and also interest and profit can be explained in this way. Land has no supply price.

The marginal productivity theory of distribution explains only *how* the National Dividend is distributed; it does not prove that the present system of distribution according to marginal productivity is perfectly just and completely justified from the ethical standpoint.

Questions

1. What is the National Dividend? Sketch briefly the general theory of distribution explaining how the National Dividend is divided among the different agents of production.

2. "The theory of payment made for any one agent in production is essentially identical with the theory of payment made for any other agent in production." Explain and discuss this statement. (C. U. 1913)

3. (*a*) What is meant by saying that wages tend to equal the marginal product of labour? Can you explain interest and profit in a similar way?

(*b*) Does such an explanation furnish any complete ethical justification of the present economic order? (C. U. 1913)

CHAPTER II

Rent

Rent.

The term "rent" is used to mean the following things:

(1) It is used generally by economists to mean *the income from land and from other free gifts of nature*. Rent in this sense includes rent from agricultural lands, rent of building sites, rent of mines, rent of pastures, rent of water privileges etc.

As the chief thing that is usually rented is land, *rent is often made synonymous with the income from land alone*.

(2) The term "rent" is sometimes used to refer to *a periodic payment for the use of land together with any capital, invested in it or on it*.

Thus the income derived by a houseowner from land and capital invested on land in the shape of a building is called in common usage *rent* Similarly the *rent* of a farm in English popular usage means the income from the farm land and also the capital invested on the land and in it in the form of buildings, roads hedges, gates etc ,

(3) Rent is also used to refer to the *payment for any differential advantage in production, enjoyed by any agent in production, (land, labour, capital* or *organization*)

This is the widest sense of the word *rent* and it includes rent in (1) which is the payment for a differential advantage in natural agents only

[*A differential advantage* means a property or quality possessed by any agent in production which causes it to have a greater economic value than the least valuable agent or factor in the same class, which is nevertheless just valuable enough to be employed

Factors or *agents of marginal capacity* are to be distinguished from *factors of super-marginal capacity* Land which is just good enough to be cultivated and which would not be cultivated if it were a little worse than it is, is an agent of marginal capacity , and land which is better than this land of marginal capacity is a factor of super-marginal capacity

Rent on superior land is paid for the differential advantage, possessed by it as compared with inferior land just valuable enough to be cultivated A labourer in a cotton mill, who is just able enough to be engaged as a worker in the mill, is of marginal capacity , and *a more efficient labourer is a factor of super-marginal capacity* and the extra-wages which he gets over and above the wages got by the labourer of marginal capacity can be looked upon as a *rent element in wages* Similarly there is a *rent element in the total profits of the employer of super-marginal capacity* due to the differential advantage enjoyed by him in production]

Rent of land

Land being the chief thing for which a rent is paid, we take up land rent first

The theory of land rent has an interesting history, and we shall notice the views of Ricardo before giving the modern re-statement of the theory of rent

(1)† The Ricardian theory of Rent

Ricardo, one of the greatest English economists of the classical school developed a theory of land rent, which is essentials may be regarded as the basis of the modern theory of rent. His theory is briefly this

Rent, according to Ricardo, is "that portion of the produce of the earth, which is paid to the landlord *for the original and indestructible powers of the soil*

Ricardo regards *rent correctly as a differential return*, (and not a monopoly return), and he has some understanding of the *operation of diminishing returns* Earlier English economists had some glimmerings of these two notions, but he is the first writer to bring these things into relation with his economic theory as a whole

The land margin is made the central point in the Ricardian theory of rent In Ricardo's law of rent we have two margins (1) resort to inferior lands leading to an extensive margin (2) the law of diminishing returns leading to an intensive margin

All lots of land in a country are not equally fertile, they are not of the same quality, some lands are of the first quality some of the second quality some of the third quality and so on

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† The following extracts from Ricardo will make clear his position 'Rent is that portion of the produce of the earth which is paid to the landlord for the use of the original and indestructible powers of the soil . *On the first settling of a country* in which there is an abundance of rich and fertile land, a very small proportion of which is required to be cultivated for the support of the actual population, or indeed can be cultivated with the capital which the population can command *there will be no rent*, for no one would pay for the use of land when there was an abundant quantity not yet appropriated, and therefore at the disposal of whosoever might choose to cultivate it *When in the progress of society, land of the second degree of fertility is taken into cultivation, rent immediately commences*

(*a*) *What is the historical order of cultivation in a country? According to Ricardo, the most fertile land is cultivated first*

(*b*) So long as the population of the country remains small, the needs of the population can be met by cultivating only a portion of the most fertile land in the country And so long as the best land is abundant and every one can have it merely by taking possession it is obvious there can be no such thing as rent *No rent is paid at this stage*

(*c*) As the population grows, the needs of the people become greater, a larger amount of agricultural produce is required, and so more land has to be cultivated *If there is a considerable increase in the population, then the whole of the first quality land will be cultivated and also a part of the second quality land* (This resort to the inferior soil is due to the operation of *diminishing returns*—if there were no diminishing returns then all the produce required by the population would have been raised from the first quality land by the application of suitable doses of labour and capital)

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on that of the first quality, and *the amount of that rent will depend on the difference in the quality of these two portions of land* When land of the third quality is taken into cultivation, rent immediately commences on the second, and it is regulated as before by the difference in productive powers At the same time, the rent of the first quality will rise In such case capital will be preferably employed on the old land, and will equally create a rent ,for rent is always the difference between the produce obtained by the employment of two equal quantities of capital and labour, *The most fertile and most favourably situated land will be first cultivated*

The exchangeable value of all commodities, whether they be manufactured or the produce of the mines or the produce of land, is always regulated by those who continue to produce them under the most unfavourable circumstances *corn is not high because a rent is paid, but a rent is paid because corn is high* ; and it has been justly observed that no reduction would take place in the price of rent Rent is not a component part of the price of commodities

The rise of rent is always the effect of the increasing wealth of the country, and of the difficulty of providing food for its augmented population It is a symptom, but it is never a cause of wealth "

(Ricardo—Principles, chapter II)

The first quality land thus bears a rent, and the amount of rent is equal to the difference between the value of its produce, and the produce of the second quality with the same expenditure of labour and capital

The land of the second quality is now said to be land on the *margin of cultivation* Land on the margin just pays for the expenses of cultivation viz wages and profit on capital, and it yields no surplus for rent Land of a superior grade with the same expenditure of labour and capital, pays the same rates of wages and of profit, and in addition leaves a surplus for rent

In course of time with a greater growth of population, it becomes necessary to cultivate land of still poorer quality, land of the third quality And *then land of the second quality will bear a rent* equal to the difference between the value of its produce and that of land of the third quality *Land of the first quality will now pay a higher rent* equal to the difference in value between the produce of the first quality and the produce of the third quality

When the third quality of land also has to be brought under cultivation, the margin of cultivation is said to descend, and the third quality is now on the margin of cultivation

With every fall in the margin of cultivation, rent increases

(*d*) Ricardo notices that *rent is due to differences in fertility, and also to differences in situation* Of two lands equally fertile, one which is more favourably situated, (which is nearer to the market and can send its produce to the market at a cheaper cost), will have the higher rent

(*e*) *Price of produce*

The price of produce is determined by the cost of production on the margin of cultivation The land on the margin pays no rent, so *rent is not an element in the cost of production on the margin of cultivation, and so rent is not an element of the price of agricultural produce*

The price of produce is thus not affected by the rent paid on superior land

† Criticisms of the Ricardian theory

(1) Ricardo maintains that rent is paid for the indestructible properties of the soil, to this some critics have objected that *the properties of the soil are not indestructible and that its fertility is often exhausted and* it may be also created by fertilisation [This objection would be valid if by soil we refer only to the top layer of the land that contains certain elements necessary to plant life, but there are *other qualities of the land that are practically indestructible and unproducible, e g*, the *climate, extent* (standing room) and the *conformation* of the land]

The four main criticisms of the Ricardian theory are given below

(3) Mr Carey, an American economist, *has attacked the Ricardian theory on the ground that it is historically false* Ricardo says that in a country the most fertile land is cultivated first and then the second quality of land and then even less fertile land and so on Carey says that experience in America shows that the less fertile high and thin, dry soils yielding a small return and requiring little clearing and draining are cultivated first and it is only later on that the lower and richer lands (requiring large expenditure for clearing and draining) are cultivated

[Carey criticised and Ricardo defended]

Carey's objections, on closer examination, lose their force

(*a*) As against Carey, Walker points out that the order of cultivation is not invariably from less fertile lands to more fertile lands even in new countries like America

(*b*) Ricardo's historical order of cultivation is not an essential part of his theory of rent And *even if we have to reject his order of cultivation his theory in its essentials, will hold true*

(*c*) And it is further pointed out that *Ricardo's order of cultivation is not historically incorrect when properly understood*

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† As Sidgwick (Principles, Book II) points out three theories are included in what is commonly known as Ricardo's doctrine of Rent—

(1) Historical theory as to the origin of Rent (2) Statical Theory of the actual determination of Rent (3) Dynamical Theory of the causes which continually tend to increase Rent A full criticism of the Ricardian doctrine must examine each of these three theories

Ricardo uses the expression 'productive land' which Carey takes to mean fertile land in the limited sense; if the expression productive land is used to include all advantages viz fertility relative to place and time, convenience of situation etc then Ricardo's historical order of cultivation from more productive to less productive lands is historically correct Moreover Ricardo speaks plainly that the *fertile* and most *favourably situated land would be first cultivated* (see page 151 footnote)

(4) Ricardo assumes equal intensity of cultivation for superior as well as inferior lands In actual fact we find that the best land is always more intensively cultivated when an inferior quality of land comes into cultivation

(5) *The Ricardian theory of rent does not apply to actual rents in the different countries of the world* It assumes full and free competition between landlord and tenant, landlord and tenant each unflinchingly seeking and unfailingly finding his best market

As a matter of fact however actual rents are determined not simply by competition but are also influenced by custom public opinion, the sentiment of the landowning classes etc

(*To this objection it may be answered that the Ricardian theory of rent like other economic laws is true only under certain hypothetical conditions*, the conditions assumed in this case being the full and free competition between landlords and tenants)

(6) *Rent and price*

Ricardo says rent does not enter into price, it does not form part of the price of agricultural produce Some critics (Cairnes etc) point out that rent in certain cases does enter into price, in Australia monopoly rents have increased prices Such monopoly rents are however exceptional cases and the Ricardian law does not apply to them

Ricardo's proposition that 'rent does not enter into price' does not also apply to rent paid for land marginal for one use but still paying rent because it bears a rent for some other use

(7) Menger, one of the leaders of the Austrian school, rejects the Ricardian theory on the following grounds

"If all lands are equally fertile and occupy equally favourable situation then according to Ricardo's theory no land could yield any rent since the inequalities of which we are speaking would not exist"

In answer to this objection of Menger the following points are to be noted

(a) All lands are not equally fertile or equally well situated, different grades of lands have to be cultivated and so the Ricardian theory applies Menger speaks only of hypothetical cases which are not to be found in the actual state of things

(b) Even if all lands are equally fertile and equally well situated, if the demand for agricultural produce is such that all lands have to be cultivated intensively then there will be an intensive margin and rent

(2) A re-statement of the theory of rent

The modern theory of rent is based largely upon the work of Ricardo Our examination of Ricardo's theory has shown that it has to be modified in certain particulars before it can be accepted as valid

The best land is cultivated first In considering which is the best land, we must take into account considerations of *locality* (*i e*, advantages of situation etc) as well as of *fertility* And the best land known in view of existing knowledge and with reference to existing resources of capital and labour, when other things are equal, is the first to be worked

The different plots of land in a country are divided into *different grades* according to differences in *fertility*, *situation* relative to the market etc

As the demand for agricultural produce increases with the growth of population, *on account of the operation of the law of diminishing returns* lower and lower grades of land are brought into cultivation It other words *the extensive margin falls*

And at the same time, the grades of land already in cultivation are more intensively cultivated *i e*, with greater expenditure of labour and capital In other words, *the intensive margin falls*

When the second quality land is brought into cultivation, the first quality is more intensively cultivated And so on (Farmers cultivate different grades of land to such different degrees of intensity that their marginal returns are equal)

Capital and labour applied to land on the extensive margin (i e, the worst land in cultivation) only pay the expenses of cultivation (wages and profits) and yield no surplus for rent The dose of capital and labour applied to rich land on the intensive margin also covers wages and profits and yields no surplus for rent

The *economic rent* of a superior grade of land is the total surplus over cost yielded by all the doses of labour and capital applied to it up to the dose on the intensive margin (See page 112 Part I)

The classical doctrine of rent may be thus restated after Prof Marshall

The margin of cultivation, and the amount of the produce

(1) The amount of the produce raised and therefore the position of the margin of cultivation (the intensive as well the extensive margin) are both governed by the general conditions of demand and supply They are governed on the one hand by *demand*, that is by the numbers of the population, the *intensity* of their need for produce and their means of paying for it, and on the other hand by *supply* that is by the extent and fertility of the available land, and the numbers and resources of those ready to cultivate it

Thus cost of production, eagerness of demand, margin of production and the price of the produce mutually govern one another

The amount of rent

(2) The amount of the rent is not a governing cause but is itself governed by the fertility of land, the price of the produce, and the position of the margin rent is the excess of that value of the total returns which capital and labour applied to land do obtain, over those which they would have obtained under circumstances as unfavourable as those on the margin of cultivation

The price of produce

The *price* of agricultural produce tends to conform to the *marginal expenses of production* (expenses on the margin of cultivation), and rent is not an element of this cost of production on the margin

Diminishing return and rent

Without diminishing returns (i.e , with constant or increasing returns), the entire agricultural produce required by a community can be produced from a portion of the best land, and inferior grades of land have

not to be cultivated And so long as the best land is abundant only a portion of it being required for cultivation, there will be *no rent paid even for the best land*

(a) *Rent results from the operation of diminishing returns when there are different grades of land in cultivation* This is what is to be found in every country (b) *Rent would result from the operation of diminishing returns even if all land is of uniform quality*

(a) The law of diminishing returns operates as regards production from land ; and the operation of diminishing return upon the best land compels farmers after a time to cultivate also inferior soils instead of applying more capital and labour to the best land When an inferior grade of land is cultivated the superior grade of land will bear a rent on account of its superior productivity and convenience of situation

(b) *Even if all land is of the same quality*, the operation of diminishing returns will lead to an intensive margin where a dose of capital and labour applied produces enough produce just to cover the cost of the dose of capital and labour applied The total surplus over cost from all the doses applied up to the dose on the margin gives the economic rent of the piece of land (Rent is measured from the extensive and also from this intensive margin)

Rent of agricultural land —

The economic rent of agricultural land is due to differential advantages, relating to fertility as well as convenience of situation. "The inequalities of situation relatively to the best market are just as powerful causes of producer's surplus (Rent) as inequalities of absolute productiveness" (Marshall) Of two pieces of land, having equal fertility, that one will have the higher rent, which is more conveniently situated by being near to markets etc. and of two pieces of land, enjoying equal situational advantages, that one will have the greater rent which has the greater fertility So fertility as well as situation are both to be considered

Rent of mines

The subject of mine rents is one of considerable complexity and the theory on this point is still in a process of development

Same peculiarities about mine rents

Prof Marshall points out that agricultural land properly cultivated retains its fertility and continues to be a perennial source of agricultural produce but that a mine is not a perennial source of minerals The stock of minerals in a mine however

large is fixed, and is exhaustible So the rent of a mine includes a *compensation for the exhaustion of the mineral*, *in this respect mine rents differ from agricultural rents Mine rents resemble agricultural and other true rents in an important respect* In agricultural rents as well as in mine rents we find the operation of *diminishing returns* leading to an extensive as well as an intensive margin We have the extensive margin—there are marginal mines just paying wages and profit on capital and yielding no surplus for rent, and also there are superior grades of mines paying wages and profit on capital and yielding in addition a surplus for rent We have also the intensive margin—the continued application of labour and capital even to a rich mine will result in diminishing returns owing to greater difficulties of sinking shafts and working at lower depths and after a time the intensive margin is reached

Two elements in mine rents

The total payment (or gross rent) paid *to the mine-owner* for the use of the mine thus *includes* (*a*) *a payment for the minerals removed* (as a compensation for the exhaustion of the mine) (*b*) *a rent proper* which is paid for the differential advantages in production relating to facilities of working and convenience of situation Of two mines which are worked with equal ease, that one will have the higher rent which is more conveniently situated as regards markets etc and of two mines enjoying equal situational advantages that one will have the higher rent which is more easily worked

(Prof Taussig makes certain interesting remarks about the rent of mines He points out (a) that mining calls for an irrevocable and usually a very large investment (b) that it involves a high degree of risk and uncertainty

In former times the risk was so great that perhaps the total outlays were not recompensed by the total net earnings, and the risk is now less than in former days but the need of large initial investment is greater

Taussig is also unwilling to accept Marshall's view that even the poorest mine will [illegible] thing to the owner as recompense for the mineral removed [illegible]

As regards buildings for *residential purposes*, situational advantages consist in natural beauty, healthfulness and fashionableness of the quarters under consideration As regards *building sites for business purposes*, whether the situation is good or bad depends upon the purpose for which the building is wanted, whether it is for retail trade or for wholesale trade, for a bank or for any other purposes

Marshall points out that building land does give a diminishing return of convenience as increased capital is put upon it "From this it results that the theory of ground rents is substantially the same as that of farm rents"

Different economic uses of land

Land may be put to different economic uses—for pasture, for agriculture, for building purposes

Generally poorest lands are used as pasture, and richer lands are used in agriculture Land which cannot be profitably cultivated for agriculture, is used as pasture—the land marginal for pasture purposes yields no rent, and the more valuable pastures pay rent As we go upwards in the scale of fertility, and according to relative demands for animal and vegetable products—land is used for agriculture, land marginal for agriculture pays no rent, and superior grades of land pay rent for the agricultural use (but land which is marginal for agricultural uses may be above the margin as pasture, and so it may pay rent as pasture though not in agriculture Again agricultural land, adapted to market-gardening near towns has a higher value and pays a higher rent than land producing ordinary crops Generally speaking land for agricultural uses pays higher rent than land for pasture, and land for building sites in towns pays higher rent than land for agriculture

Personal rent

Personal rents closely resemble fertility rents

All employers are not of equal efficiency—one employer can get more value out of his factors of production than another and can manage a bigger business If the second employer is the marginal employer then the extra earnings of the first employer may be regarded as a personal rent due to his superior efficiency

Then as regards professional men There is the lawyer of marginal capacity and also the lawyer of supermarginal capacity The extra earnings of the lawyer of supermarginal capacity may be regarded as his *personal rent*

So also as regards the wages of workmen. There is the carpenter of marginal capacity, just good enough to find employment. A carpenter of super-marginal capacity will earn higher wages than a carpenter of marginal capacity. The extra wages earned by the carpenter of super-marginal capacity, due to his superior efficiency may be regarded as the personal rent of the superior carpenter.

There is thus a rent element in profit, a rent element in professional earnings, and a rent element in the wages of workmen, and this personal rent is the payment for a differential advantage, possessed by that person in the work of production.

Rent and the price of agricultural produce

Is rent an element of the price of agricultural produce? Does the rent paid on superior grades of land affect the price of produce in a country? Is high rent the cause of high price of produce?

If the quality of the agricultural produce is the same, the price of produce is the same in the same market whether it has been produced by superior or inferior land. In a country, the most fertile land produces an equal amount of produce at less cost (of labour etc.) than land of inferior quality.

The price of agricultural produce in a country will equal the marginal expenses of production (*i.e.* the cost of production of the most expensive portion of the normal supply that portion which is produced at the greatest disadvantage) otherwise this portion of the supply will not be produced, and so the total supply of agricultural produce will fall short of the total demand. Now rent is not paid on the poorest land in cultivation (land on the extensive margin), and there is also no rent on the intensive margin of superior land for the marginal dose produces just enough to cover only the cost of the dose and leaves no surplus for rent, *rent is not an element of the marginal expenses of production. So rent is not an element of the price of agricultural produce which is determined by these marginal expenses. High rent is not the cause of high price of agricultural produce.*

[The increasing demand for produce leads to high price of produce and this high price of produce makes profitable the cultivation of even low grades of land (and also the intensive cultivation of superior grades of land), and thus leads to payment of high rent for the superior grades of land. *High rent is thus the effect of high price, and not its cause.*]

Will the remission of rent affect price?

No If the landlords remit rent upon the superior grades of land, then these rents will be appropriated by the tenants of the landlords The price of agricultural produce will not be affected The demand for agricultural produce will remain the same, the margin of cultivation will remain unaltered, and so also the marginal expenses of production and so the price of agricultural produce will remain unaltered

When does rent enter into price? Imp

We have seen that rent does not enter into the price of produce because rent is not an element of the marginal expenses of production,

In those exceptional cases where rent is an element of the marginal expenses of production, rent will enter into the price of produce

(*a*) If the state has a monopoly of land in a country, and if it exacts a rent even for the use of the marginal land (the poorest land in cultivation), then this rent will enter into the price of agricultural produce

In large portions of India, the state is the monopoly landlord and it charges a monopoly rent even for marginal land, and this monopoly rent entering into marginal expenses of production influences the price of agricultural produce

(*b*) When rent has to be paid even on marginal land for one use (*e g* agriculture) to withdraw it from another use (*e g* pasture), then this rent paid for marginal land will enter into price

Indirect consequence of rent payments may have also influence on price

Suppose there is a rise in the rent of grazing land and suppose this leads to the conversion of some arable land to pasture There will be shortage of arable land, there will be less total agricultural produce from the land and thus the price of agricultural produce will rise Here we see that rise in the rent of grazing land may indirectly bring about a rise in the price of agricultural produce

Rent and the price of land

We have seen that *the value of the produce of land determines rent, and rent in its turn determines the value of land*

High price of agricultural produce leads to high rent, and high rent will bring about a high value of the land

Suppose one piece of land has got such differential advantages over land on the margin that it bears a rent of £10 per annum

If the current rate of interest is 10 % per annum, this piece of land with an annual rent of £10 will be regarded by owners

and other persons as equal to capital of the value of £100 If the current rate of interest is 5% per annum then the value of the piece of land will be £200

So in a country where the supply of capital is large and the current rate of interest is low, where there is perfect security of life and property, and where great social prestige is associated with land ownership, the price of a piece of land will be many times its annual rent. Where these conditions are less favourable the price of land will be lower

Ricardian Rent and actual conditions governing rent in different countries.

How far is the Ricardian doctrine of rent applicable to actual conditions in different countries?

The Ricardian doctrine of rent is true only hypothetically i e it is true upon the assumption that the landowner as well as the tenant, each understands fully his own economic interests and that there is full and free competition and that the landlord of the tenant is not influenced in any way by other forces, like custom, public opinion, sympathy for the tenant etc

Now let us examine actual conditions in different countries

(1) *The United States, Canada, Australia etc*

In these countries we have the nearest approximation to the hypothetical conditions assumed in the law of rent

The tenant and the landlord are substantially on an equality as to intelligence, enterprise and mobility Each understands his own interest fully, competition is full and free between them And the rent is determined almost exclusively by competition and is the *nearest approximation to economic rent* (i e rent according to the Ricardian theory)

(2) *England*

In England Ricardo's law furnishes the great underlying principle according to which rents are primarily determined with more or less divergences from local or individual causes Actual rent in England is primarily determined by competition between landlords and tenants but the landlords are prevented from exacting the whole economic rent by public opinion and also by their class sentiment

The tenants are regarded as being not on an equality with landlords they are looked upon more or less as dependents them Public opinion demands that the landlords should not very strict in their demand for rent and this is also the sentiment the land owning classes themselves, and so the *landowners exact ss than the full economic rent*

(3) *Continental Europe India*

In Switzerland France Italy and also in India rents were formerly paid almost universally not by competition (as it is assumed in Ricardo's law) but by custom

At present in India rent depends upon three factors—custom, competition and legislation The rent law of India starts from a basis of custom accepts the legitimate influence of competition and seeks by legislation to restrain competition between landlords and tenants within reasonable limits Rents in India are rising with the rise in the price of agricultural produce and increasing competition but an excessive increase of rent is prevented by the rent law of the country

"Custom is still to a large extent, the foundation of Indian rents, and the presumptions of unfettered competition, which pervade the standard economic conceptions of rent (i e Ricardian rent) can only be applied with large reservations to existing conditions in India" †

(4) *Ireland*

We have seen that in England and also in continental Europe the actual rent received by the landlords is lower than the full economic rent The action of competition is moderated in favour of the tenants by public opinion and class sentiment in England and by custom in continental Europe

In Ireland the actual rents paid by the tenants to landlords sometime ago were in excess of the full economic rent (the economic maximum)

The excessive competition for land between the tenants, sanguine, improvident and extremely prolific, led them to offer rents in excess of the economic maximum, and the absenteeism of the landlords and collection of rent through heartless agents and middlemen aggravated the situation

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† Imperial Gazetteer of India Vol III

Quasi rents

Certain kind of income analogous to rent are called quasi-rents.

Prof Marshall thus defines quasi-rent "*The net incomes from appliances for production already made may be called their quasi-rents* partly because we shall find that when we are considering periods of time too short to enable the supply of such appliances to respond to a change in the demand for them, the stock (of these appliances has to be regarded as *temporarily* fixed For the time they hold nearly the same relation to the price of the things which they take part in producing, as is held by land or any other free gift of nature, of which the stock is *permanently* fixed and whose net income is a true rent"

Appliances for production include machinery factories and other buildings, also business ability and manual skill etc, and so there will be quasi rents from machinery factories and other buildings also quasi-rents from business ability and manual skill etc

In the short period, the supply of these various appliances has not the time to be fully adapted to the demand The particular income derived from them in the short period, does not for the time affect perceptibly the supply, nor therefore the price of the commodities produced by these appliances it is a surplus of total receipts over prime (money) cost *And this excess of the value of commodities over cost produced by the appliances during the short period, has enough resemblance* to *the excess value of the produce of land over cost to justify us in calling it a quasi rent*

When there is an increased demand for one factor in production which makes its earnings more than normal, we may speak of *positive quasi-rents* And when conditions arise which make the earnings of a factor in production less than normal, we have *negative quasi rents* When the demand for engineers falls off, their earnings become less than normal, and they earn negative quasi-rents

Rent proper and Quasi-rent

Quasi-rent resembles rent proper in this that it also results from a limitation of supply, quasi rent † results when the stock of an appliance is *temporarily* fixed, rent proper of land results from the *permanent limitation of supply* of land,

† Quasi-Rent is not something like rent but temporary rent (Smart)

In the short period, there is a close resemblance between quasi-rent and rent proper In the short period, the quasi-rent derived from an appliance (the stock of which is temporarily fixed) does not for the time being affect the supply, nor therefore the price of commodities produced by the appliance The rent from land also does not affect the supply nor therefore the price of the produce of land

In the long period, the supply of an appliance from which a quasi-rent is derived can be fully adjusted to the demand for it, and so if the quasi-rent from the appliance does not in the long run amount to normal profits on capital and effort, the supply of the appliance will dwindle and it would not contribute its part to production True rent from land will differ from quasi-rent in this way—even if true rent ceased the supply of the free gifts of nature would remain undiminished and these gifts of nature would continue to take their part in production

Rent and Social Progress

Social progress in different directions affects rent in different ways

(a) Other things being equal, growth of population and of prosperity lead to an increased demand for land, the margin falls and there is an increase of rent

(b) *Agricultural improvements* e g the introduction of new and more powerful fertilisers, better rotation of crops etc would enable a given area of land to produce a larger amount of produce, and so the total agricultural produce required by the country would now be obtained from a smaller area of land than before, and therefore some of the poorer grades of land would not be cultivated, the margin of cultivation would ascend, and rent would fall *Agricultural improvements increasing the produce from a given area of land thus tend to diminish rents*

(c) *Improvements in means of communications*

Like agricultural improvements, improvements in means of communication affect the margin and influence rents

(i) *If these improvements in transportation connect a place with a new market where this agricultural produce can be sold at a higher price, then the rent will tend to increase* Rents in America have risen with improvements in transport which enable American farmers to produce large quantities of corn for export to England The demand

for agricultural produce for the purpose of export increases the demand for land in America the margin falls and rent increases

(ii) *Improved means of communications connecting a country with a new source of supply of agricultural products will tend to reduce rents in that country* Increased facilities of communication the development of steam navigation and railways have made England look upon the United States as a source of supply of agricultural products the poorer grades of land in England have been thrown out of cultivation by the competition of American produce the margin of cultivation has risen in England and so rent of agricultural land has fallen

Improvements in internal means of communications within a country will tend to increase the rent of land distant from the market The comparative inconvenience of situation of land distant from the market is decreased by improvements in communications

The unearned increment of land

Though the idea may be traced in earlier economists the term 'Unearned Increment' was first used by John Stuart Mill

As the margin of cultivation falls on account of the growth of population and increased demands for produce the rent of land increases,—and in this way the value of agricultural land may increase without any effort on the part of the landlord Similarly growth of population and increased prosperity in a town will bring about an increase in ground rents and an increase in the value of urban land This kind of increase in the value of land which is due to social progress, (growth of population and prosperity) and is not due to anything done by the landlord is called the '*unearned increment of land*' (Any increase in the value of land brought about by an expenditure of labour and capital by the landlord would be of course earned increment legitimately earned by the landlord)

In Bengal, the Government settled the land revenue with the zemindars permanently by the Permanent Settlement of 1793 So the zemindars pay fixed land revenue to the Government, and they (many of them) receive an enormous unearned increment from the land due to growth of population and prosperity In large towns like Calcutta and Bombay there is a large and rapid increase in the unearned increment of land

The argument for the appropriation of the unearned increment by the state

As the unearned increment is not in any way due to the landlord but is due to the progress of society, in fairness it should be appropriated by society and not by the landlord

This view has been advocated by John Stuart Mill and also some other distinguished economists, and in an extreme form it has been advocated by Mr Henry George

Proposals of Mr Henry George and Mr J S Mill etc

Proposals for appropriating the unearned increment, by the state are of different kinds

(1) Some propose that the entire unearned increment, past and present, from all kinds of landed property should be appropriated by the state and without any compensation given to the landlords This is Mr Henry George's scheme In Mr George's scheme, the entire rent is taken by the state from the landlord and the landlord gains nothing from his possession of land The land practically nationalised becomes in fact though not in name the property of the state

(2) *John Stuart Mill* proposed about fifty years ago (and his suggestion has been repeated by other writers) that the land in a country should be subjected to a periodical valuation by the Government and that any increase in the value of land not due to the labour and capital of the proprietors should be taken over by the state by a tax upon the unearned increment

The proposal of Mr John Stuart Mill was *chiefly with reference to agricultural land* and it was *the future increment* that was to be taxed

The suggestion of Mill and that of other reformers of his time have been rejected by modern economists on certain grounds

(3) The unearned increment is greater as regards land in towns than in agricultural land and so the taxation of unearned increments in towns finds more supporters at the present day than the taxation of the unearned increment of agricultural land *The state may take part of the unearned increment or it may take the whole of it by a tax* In some modern states (*e g* England and Germany) the state through taxation appropriates part of the unearned increment The appropriation of the entire unearned increment has not yet been attempted by any modern Government

Objections and practical difficulties in connection with the taxation of the unearned increment

(1) First of all there is *the difficulty of ascertaining exactly the amount of the unearned increment* The rise in the value of land is due partly to labour and capital of the proprietor and partly to social progress And in practice the work of calculating how much is due to the labour and capital of the proprietor, and how much is pure unearned increment is a very complex and difficult task

A tax taking more than the unearned increment would be unjust, such a tax on agricultural land *would discourage agricultural enterprise* and is incompatible with good husbandry and a tax of this character on urban land would discourage the effective utilization of urban sites

(2) Again it is difficult to find out whether the man in actual proprietory possession of the land is getting an unearned increment or not He may have bought the land from some other man at its full value and here the seller has got the unearned increment and the buyer in possession has got none

These are practical difficulties in the taxation of the unearned increment

(3) Then there is an objection on the score of principle *If the state takes unearned increment* due to social causes (and not to any efforts of the individual proprietor of the land) it is only just and reasonable that the *state should pay compensation to the owners of property which is depreciating* (not through any fault of the proprietor but through social causes and changing economic conditions), but the state does not pay such compensation

† Nationalisation of land

The nationalisation of land means the extinction of all private proprietory rights in land and making all land the property of the state

The nationalisation of land has been advocated by socialists and also by persons who are not socialists and who are willing to

† In India the State has rights over the land from time immemorial and the British Government has recognised also private property in land "The Indian system of land tenure is something intermediate between complete nationalisation of land and absolute private property in land" (Indian Industrial Organization—Morison)

allow the private ownership of capital (but not the private ownership of land)

The two important systems proposed for land nationalisation are the following —

(1) The state as owner of the soil should lease the land to individuals, who should cultivate it as tenants of the state

(2) A second system suggested by John Stuart Mill and brought into prominence by Mr Henry George is to put such a progressive tax* on landed property in the hands of the landlords as would absorb the entire economic rent

The question arises as to whether this nationalisation of land is to be effected by paying compensation to the present owners of the land or whether the state is to take the land from the private owner without paying any compensation

(*a*) Land Nationalisation without compensation

In the words of Mr Montague who writes on this subject in the Dictionary of Political Economy, "*Nationalisation of land effected without compensation* or with merely nominal and delusive compensation *is open to the objections based on law, morals and public policy*, which can be brought against the abolition of all property whatsoever and to the additional objection of making one class (the land-owning class) a victim to all other classes"

(*b*) Land Nationalisation with compensation

There are also strong objections to nationalisation of land with compensation

* Mr Henry George's theory of the Single Tax

Mr Henry George holds the view that all men have an equal natural right" to the land and that therefore the entire economic rent of the land should go to society—the economic rent should be appropriated by society through a *Single Tax* upon land which would absorb the whole economic rent

This single tax on land would be so productive as to make all other kinds of taxation unnecessary And Mr George further holds that the single tax on land is the only just tax and all other kinds of taxation are unjust because they interfere with the natural right of a man to the fruits of his own labour.

(1) The difficulty about purchases of the land from the private proprietors

(*a*) The total amount of compensation to be paid by the state to landowners will be a very heavy one How is this amount to be raised by the state? The *fiscal difficulty* would be insurmountable

(*b*) If the state manages the land itself a costly public department with an immense staff would be required for the work

(2) And *if land nationalisation is effected with suitable compensation* to landowners it will often be *not very profitable to the state* and sometimes it may end in actual loss If the state in England had bought agricultural land in Mill's time it would have been a loser on account of the fall in the value of land

(3) And under the system of a state department granting leases to tenants for varying periods, *the risk of corruption* and *favouritism* would be very great

(4) The state as landlord will not be able to supply capital as efficiently as private landlords for agricultural improvements and so agricultural improvements and progress will be discouraged

The question of nationalising all the land held in private ownership within a country is thus impracticable under present conditions As regards future property that is to say the concession of new lands granted by the state to citizens (specially in new countries like Australia, Canada and the United States) the state would do well to retain its property in the soil and thus help towards solving the social problem for the future generations

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And in the opinion of Mr George the single tax upon land will abolish the problem of poverty, the proposed single tax would dispense with the necessity of imposing other taxes and it would make poverty disappear

Criticisms of Henry George s single tax theory

The claims of Mr, Henry George in favour of the single tax cannot all be substantiated

(1) His contention that the single tax is the only just tax is based upon an untenable theory of natural rights (2) And his claim that the single tax will abolish poverty is utterly unfounded and is not supported by facts

Land Tenures

The contract rent taken by the landlord from the tenant often diverges from the pure economic rent of land The economic rent of land is the surplus above cost of production

The actual contract rent differs from the economic rent on account of economic friction Where there is ignorance, lack of opportunity or lack of mobility on the part of the tenant, actual rent may be higher than economic rent

Again where on account of social or other reasons the land-owner does not exact from the tenant the whole of the economic rent but only a part of it, the actual rent may be lower than the economic rent

Early Tenures

As Prof Marshall points out early forms of land tenure are generally based on partnership

The two partners are (1) the tenant who is the working partner and (2) the state which is the sleeping partner The produce of the soil is divided between the state and the tenant This system existed in ancient India and it also prevailed in many other ancient countries

† Metayage (or rental by shares)

Under this system the *rent* instead of being paid in money and being invariable during the term of the lease is *paid in kind* Often one-half of the harvest is paid as rent by the tenant to the landlord, but the proportion is not the same in all places The tenant supplies labour, he works himself with his family, and some times he hires a few labourers, the landlord supplies land and generally also capital in the shape of farm buildings, cattle, and in some cases even farm implements

The metayage system is much in use in certain parts of Europe particularly in Italy, Portugal, Russia and the countries of the Danube, and also in portions of France We have it here also in Bengal where it goes by different names (*bhag, batai etc*) in different parts

† For metayage in India, refer to Morison's Indian Industrial Organization (Chapter III)

It is a fact worthy of notice that the proportion of land cultivated under the metayage system has diminished considerably in Europe; and it is also diminishing in India

Advantages of the Metayage system

The following advantages can be claimed on behalf of this system

(1) *Metayage creates a common interest between the landlord and tenant* by making them partners in good fortune and in bad Under other systems, the landowner and the tenant have conflicting interests

(2) *A poor man can become a metayer tenant*, because he has not to supply capital Unlike an English tenant farmer who has to pay the same money rent in good as well as in bad years, the metayer tenant has to pay only a proportion of the actual produce to the landlord as rent and so even in bad years *the metayer tenant is not in distress about his payment of rent*

(3) Competition between farmers paying money rents often sends up money rents to an excessively high level, but this is not possible under the metayage system which fixes by custom the shares of the landlord and the tenant

(4) Again under metayage, the landlord does not gain much by changing his tenant and so this system is more favourable to *long leases*

(5) The amount of rent received by the landlord being a share of the produce depends upon successful cultivation and so the landlord takes interest in the cultivation and sees to its improvement This benefits the metayer tenants and also improves the standard of cultivation

The unity of interest between landlord and tenant established by metayage, and the benefits it confers on the metayer tenant are conducive to social peace

Prof Marshall holds that the advantages of the metayage system are considerable when the holdings are very small, the tenants poor, and the landlords are not averse "to taking much trouble about small things, but it is not suitable for holdings large enough to give scope to the enterprise of an able and enterprising tenant"

The disadvantages and defects of metayage

(1) An able and enterprising tenant would prefer a fixed money rent because then whatever he produces above that would be his

Under metayage he has to give a part of the product due to his superior capacity to the landowner A metayage farmer has also less freedom and responsibility than an English farmer

(2) And the landlord has to take a great deal of trouble for the land under metayage which he has not to do under the English tenant system

The land owner lends capital, and he gets only a portion of the additional net product due to his capital This seems to be a poor investment to the land-owner, and discourages investment of capital in the land

For these reasons *metayage* is regarded as being *unsuitable for progressive cultivation*

The metayage system is not well suited for large holdings requiring a considerable expenditure of capital, and efficient and enterprising management on the part of the tenant

It has been suggested by Professor Gide that the contract of metayage may be modified according to circumstances, with a view to adapt it to progressive cultivation The metayer, for example, may contribute a large amount of capital, or the landowner may advance it at a moderate rate of interest

Peasant Proprietorship

When the peasant is the proprietor of the land he cultivates, we have the system of peasant proprietorship The land is his own, he supplies the greater part of the labour working himself with his family and he also supplies the capital He supplies *land, labour and capital*, and the entire produce consisting of rent, interest, wages, and profits goes to him

The system of peasant proprietorship prevails largely in France, in Belgium and in certain parts of the United States In the United States, the peasant proprietor uses to an important extent hired labour and borrowed capital

Advantages of Peasant Proprietorship

The advantages of this system are very considerable

(1) The peasant knows that he is the proprietor, that the entire product will go to himself This immensely stimulates his energy and industry

In the words of Arthur Young "Give a man the secure possession of a bleak rock and he will turn it into a garden The magic of property turns sand into gold"

(2) The system of peasant proprietorship not only makes the peasant most industrious and hard working it also improves his character in other ways The sense of proprietorship gives him self respect

And the desire to improve his land by spending capital on it makes him temperate and thrifty in his habits He is scarcely ever idle and seldom regards his work as mere drudgery, it is all for the land that he loves so well

(3) Again a large body of peasant proprietors affords a steady bulwark against political and still more against social turbulence

Disadvantages —

(1) Marshall is of opinion that *the peasant proprietor is generally an industrious but seldom an efficient worker.* The peasant proprietors generally stint the food of themselves and their families, sometimes live in their kitchen for economy and are practically worse housed and fed than the better class of English cottagers The efficiency of peasant proprietors is therefore low and though they work long hours they generally get through little work

Wealth is only a means to an end which is happiness, the *peasant proprietors sacrifice the end to the means*

(2) It depresses the birthrate and prevents a suitable expansion of population

(3) The system of peasant proprietorship is not so favourable to scientific cultivation as the English system The peasant proprietors have not much capital at their disposal and they are also not so educated and enlightened they do not understand very well scientific improvements and they have also not the means to carry out these improvements

As regards the disadvantages of peasant proprietorship it may be pointed out that a deliberate check exercised upon the growth

of population is confined not only to peasant proprietors but is also to be found among the artisans of the towns and in a very appreciable degree among the upper classes And this prevention of over-population among the agricultural and the artisan classes is really desirable from their point of view under certain circumstances

Then for the third objection Increasing diffusion of education is making peasant proprietors capable of appreciating the merits of scientific cultivation, and co operation and other suitable agencies are increasing their resources with which they can introduce up to-date scientific methods and machinery

The disadvantages of peasant proprietorship are prominent in old countries, where the peasant proprietors are comparatively uneducated and have limited resources

And in countries where the peasants are properly educated and have sufficient command over capital, proprietorship offers very great advantages In the words of Taussig "A wide diffusion of the ownership of land and the predominance of cultivation by the owners are the most wholesome agricultural conditions"

The Indian peasant is industrious and hard working Thrifty he is within limits, and also honest and temperate to a degree And he has a great love for the land With more education, and with a sufficient command over capital provided by cooperation and other agencies, he should make an ideal peasant proprietor At present their is a sort of dual ownership—the landlord has rights of property over the land, and also the tenant who has in many cases occupancy and other rights, and as in Ireland so in India, a large development of peasant proprietorship is expected to do a deal of good in the future †

The English system of Land Tenure

In England, peasant proprietorship existed in the Middle Ages But in course of time, the peasant proprietors have been replaced by tenants, holding land under the present system of tenure The present system is this—the land of the country is owned by a few great landowners, the landowner leases the

†Morison—Indian Industrial Organization (Ch IV)
Ranade—Essays in Indian Economics

land to a tenant, and the tenant is generally a large capitalist farmer, cultivating the land partly with his own capital and partly with capital supplied by the landlord. The tenant farmer hires labourers on fixed wages to work for him. So under this system we have the landlord, who supplies the land and also a great part of the capital (about $\frac{5}{6}$ of the total capital employed on the farm) in the shape of buildings etc, the tenant farmer supplies part of the capital and the management and there are also hired labourers engaged by the tenant farmer. The lease is for varying periods and generally for short periods. *The rent is determined chiefly by competition.*

The landlord gets rent which includes some economic rent and also some interest on his capital, the labourers get only wages and nothing more and the tenant farmers receive interest on their capital and profits of cultivation.

Under suitable conditions *i.e.* when the landlords are prosperous and not exacting and the tenants capable and industrious, the English system has great merits.

The Merits of the English system

(1) The chief merit of this system is" as Marshall points out "that it enables the landlord to keep in his own hands the responsibility for that part of the property (land, buildings and permanent improvements) and only that part which he can look after with but little trouble to himself and little vexation to his tenants.

(2) The landlord supplies $\frac{5}{6}$ of the capital and he supplies this capital to the tenants at an exceptionally cheap rate (about 3 p. c. interest on cost.) This greatly helps the tenants.

(3) Unlike the landlord under the metayage system, the English landlord has considerable freedom in the selection of an able and responsible tenant.

This cheap supply of capital and the selection of able tenants make possible scientific cultivation and a high standard of agriculture. The English system on the whole tends to promote the discovery and diffusion of improved methods, and it stimulates and economises enterprise and energy in agriculture.

Demerits

The English system with all its merits suffers from certain defects.

(1) The landlords in selecting tenants are not guided by strict business principles They do not try to get always the ablest tenants, who will make the best use of the land In this way, there is a loss of efficiency

(2) The dependence on the landlord is distasteful to many able men who would prefer the system of peasant proprietorship and these men, in the absence of peasant proprietorship would engage in manufacturing and other industries rather than engage in agriculture.

(3) The position of the labourers is not a satisfactory one, they get only wages and have no other interest in the land

Marshall remarks "Faulty and harsh as it has been in many respects, it yet had a great power of stimulating and economising that enterprise and energy which gave England the leadership of the world in manufacture and colonization and though in a less marked degree in agriculture"

Conditions and limitations on large scale production in agriculture Large scale production in agriculture cannot be carried to the same lengths as in manufacture The causes of this are the following

(*a*) Agriculture must be spread over the broad land, thousands of agricultural workers cannot be concentrated on a small area and agricultural operations are not easily subjected to a fixed routine Both these circumstances make effective supervision difficult

In manufactures, on the other hand, thousands of workers can be concentrated within a small area, even under a single roof and the work may be divided into routine tasks of different kinds assigned to different classes of workers This makes effective supervision in manufacture even on a large scale possible And so large scale production is carried to much greater lengths in manufacture than in agriculture

(*b*) In agriculture there is a great dependence upon the seasons and the use of machinery is not so large as in manufacture These things also work against the establishment of large scale production in agriculture to the same extent as in manufacture

The scale of farming in each country depends upon various economic, political and social factors

In England we have farming on a larger scale than in India Even in England however an increase in the scale of agriculture is prevented by the following facts

(*a*) High-grade business ability is required for successful large scale agriculture In agriculture the farmer has to do the higher work of management and he has also to waste his time upon much work which

is really below him The earnings of business abilities are therefore not so high in agriculture as in manufacture and other industries, and so the best men leave agriculture for other occupations

(b) Again an increase in the scale of agriculture will require farm buildings and means of communication specially adapted to it, and it would have to overcome a good deal of resistance from custom and sentiment not altogether of an unhealthy kind (c) the risk of failure for pioneers in this work would also be great

In India, of course we have the general limitations on large scale agriculture which exist in all countries We have in addition the following circumstances limiting the scale of production in Indian agriculture

(1) The system of small holdings
(2) The law of inheritance which favours subdivision of holdings
(3) Absence of suitable agencies for supplying cheap agricultural capital

(4) We have also not a capable class of farmers having that knowledge of scientific agriculture machinery and markets, necessary to make large scale cultivation a success

(5) The risk of failure for pioneers will be greater in India than in England and the people less able to bear it

(6) The resistance offered by custom and sentiment to the extension of scale in agriculture is much greater in India than in England

The introduction of peasant proprietorship in England

Prof Marshall is of opinion that for England the present system is on the whole the best, and peasant proprietorship is unsuited to the economic conditions of England to her soil and climate and the temper of her people

Marshall however points out that *within certain limits peasant proprietorship as a system of land tenure has its place even in England* There are certain types of men who have a great capacity for growing fond of the land who would work hard and live sparely if they have not to call any man their master and these men are specially fitted to be peasant proprietors and there should be no artificial hindrances to their acquiring peasant properties

The obstacles in the way of peasant proprietorship in England are the following—

(1) *There are the obstacles which the law presents*
(a) The law of primogeniture which prevents the land from

being divided among the children This debars most citizens from owning the land

(b) The law of entail This prevents those priviliged persons who own the land from easily disposing of it

(c) The law of conveyancing which makes the sale of land a complicated and vexatious affair

The obstacles should be and are being gradually removed

(2) *Social obstacles*

The social prestige which attaches to the possession of large landed estates makes the owners unwilling to sell And so persons who want to purchase land for peasant properties find it difficult to get the land

The English system of land tenure has its advantages under suitable conditions, so also peasant proprietorship and also metayage

The suitability of land tenures in a country depends upon local economic and political conditions, historical antecedents, traditions and customs relating to the cultivation of the land *In general*, peasant proprietorship co existing side by side with large and middle-sized farms—this is wanted in every country though not in the same proportion

The Cottier system of land tenure in Ireland

The cottier system is the most unsatisfactory kind of land tenure It is a sort of caricature of the English system In the cottier system of Ireland, the competition between landlord and tenants is extremly unfair to the tenants, the tenants are not comparatvely well-to do capitalist farmers but poor peasants cultivating small holdings The absence of alternative occupations brings about an excessive competition among tenants for the land The landlords taking advantage of this competition demand a rent from the tenants higher even than the economic rent (and according to Fawcett in some cases even higher than the total produce of the land) The tenants promise to pay but cannot pay so much and are always in arrears to the landlords and the tenants have not even enough for their own necessaries The results of the cottier system are a *poor and heavily indebted peasantry*, a peasantry absolutely dependent upon the landlords and almost reduced to the position of serfs and *a hopelessly inefficient system of agriculture*

The evils of the cottier system are increased by the absenteeism of the landlords and by the rapacity and unscrupulous character of the middlemen who collect the rents of the landlords

The cottier system is being gradually replaced by better arrangements, peasant proprietorship and other things A large number of legislative measures passed by the British Government has brought about a great and salutary change in the condition of the Irish peasantry and the state of Irish agriculture

Summary

1 *Rent in economics* is used to mean (i) income from land and other free gifts of nature (ii) and *in a wider sense* payment for any differential advantage in production enjoyed by any agent in production (viz land labour, capital or organization)

2 Ricardo's contribution to the theory of rent is very important Rent, according to Ricardo, is paid for the indestructible properties of the soil, and it is a differential return Historically the best land is cultivated first, and (to meet the growing demand for produce and on account of the operation of diminishing returns) worse and worse grades of land have to be cultivated As the margin of cultivation descends, rent increases Rent is not an element in the price of agricultural produce

Objections

Some objections usually urged against the Ricardian theory are (i) rent is not paid for the indestructible properties of the soil (ii) the best land is not always cultivated earlier than the inferior grades (iv) the Ricardian theory of rent does not apply to actual conditions in many countries (v) rent in certain cases does enter into price

3 Prof Marshall's masterly re-statement of the classical doctrine of rent gives a clear and comprehensive explanation as to how margin of cultivation, the amount of produce, the amount of rent, and the price of produce are determined, and the relation between them Rent is a surplus above cost

4 There is an intimate connection between the law of diminishing returns and rent Without diminishing returns, there would be no rent

5 The *rent of agricultural land* is due to differential advantages relating to fertility and also convenience of situation *Rent of mines* includes (*a*) rent proper (*b*) and a payment as compensation for the exhaustion of minerals Situation is the factor of special importance in determining the rent of *urban sites*

6 Actual rents are less than the economic rent in England under the influence of public opinion and class sentiment, they are less than the

economic rent in many countries of Europe under the metayage system on account of the influence of custom, but were greater than the economic rent in the Ireland of sometime ago

7 Rent is not an element in the price of agricultural produce—the payment of rent does not affect the price of produce in the market Rent is not the cause of the high price of produce, but high rent is rather the effect of the high price of produce

8 The value of agricultural produce determines rent, and rent in turn determines the *value of land*

9 *In the short period*, the net incomes from the appliances for production (viz machinery, factory buildings, business ability etc) have enough resemblance to true rent to justify us in calling them *quasi-rents*

10 Rent is affected by *social progress* in different ways The causes which make the margin of cultivation fall bring about an increase of rent, and the causes which make the margin ascend bring about a fall of rent

11 The argument for the *taxation of the unearned increment* is this The unearned increment is something which is not earned by any expenditure of labour and capital by the landlord, but is due to social progress, and so should be appropriated by society

Objections The usual objections advanced against the taxation of the unearned increment are (i) the state is not justified in taxing unearned increment because it does not pay compensation to owners of depreciating property (ii) practical difficulties about (*a*) ascertaining the exact amount of the unearned increment (*b*) and finding out the person who is in actual enjoyment of the unearned increment

12 *Nationalisation of land* may be (*a*) with compensation (*b*) without compensation to the existing proprietors of the land Nationalisation without compensation is opposed to law, morals and public policy And as against nationalisation with compensation, the principal objections are (i) the fiscal difficulty in connection with the purchase of the land by the state (ii) the expense of managing the land by a costly public department (iii) the risk of corruption and favouritism

13 The *metayage system* has very considerable advantages when the holdings are small, the tenants poor and the landlords willing to take a great deal of trouble but ordinarily it is not quite suitable for progressive cultivation *The English system* with all its defects and harshness is very well adapted for scientific cultivation and a high standard of agriculture, and has great power of stimulating and economising energy The system of *peasant proprietorship* suffers from certain defects in countries where the peasants are ignorant, unenterprising and have limited resources, but it offers very considerable advantages, and ... wholesome system where the peasantry have education,

energy organization and a sufficient command over capital Marshal admits that within a limited sphere there is scope for peasant proprietorship even in England but there are obstacles to be overcome

Questions

1 What are the different senses in which the word 'rent' is used? What do you understand by factors of marginal capacity and factors of supermarginal capacity

2 State and examine the Ricardian theory of rent (1912, 1910)

3 (a) Give briefly Marshall's re-statement of the classical theory of rent

(b) What is the relation of the Law of Diminishing Return to Rent? (1911)

4 Describe how (a) rent of agricultural land (b) rent of mines (c) rent of building sites are determined

5 (a) Discuss the proposition 'Rent is not an element in the price of agricultural produce' (C U 1900)

(b) How is rent related to price? (1912 H)

(c) What is the relation between the rent of land and the price of land?

6 Do actual rents in England in continental metayer countries and the United States correspond to the rent of Ricardian theory?

7 (a) Write a note on Quasi-rent (C U 1914)

(b) Explain Quasi-rent and discuss the relation between Quasi-rent and true Rent (1912 H)

8 Discuss the effect upon agricultural rents (a) of agricultural improvements (b) of improvements in internal means of communication (c) of opening up of a new source of supply of agricultural products (C U 1912)

9 What do you understand by the Unearned Increment? State briefly the argument in favour of the taxation of the Unearned Increment. Point out the practical difficulties and the theoretical objections to the taxation of the Unearned Increment

10 What is nationalisation of land? Consider the questions of (a) nationalisation with compensation (b) nationalisation without compensation

11 Give short sketches of the following system of land tenure pointing out merits and defects

(a) The metayage system (b) peasant proprietorship (c) the English system

12 Remark on the characteristic merits of peasant proprietorship. Would you advocate the compulsory introduction of such a system in England? Give reasons for your answer (C U 1900)

CHAPTER III

WAGES

The Wages Question

In modern industrial communities like England, France, Germany and the United States, most men (and a large number of women) are wage earners For the vast majority of the people in these countries, the wages question is the great economic question, the fundamental problem relating to their economic status, prosperity and progress

The problem relating to wages is one of great complexity influenced by an immense variety of factors, economic, political, social and ethical "The wages question is a question of culture" (Brentano)

Wages

Definitions of Wages

(1) *Prof Gide's view*

The word "Wages" is sometimes defined by economists to mean the income received by a person for his labour This definition is regarded by Prof Gide as too wide

And Prof Gide remarks that the term wages should be applied only to the remuneration for labour, performed under certain conditions, *the word wages should be applied* not to mean the price of every kind of labour, but *to the price of labour, hired and employed by an entrepreneur*

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† In countries like India which have not yet fully adopted the modern industrial organization, large numbers of workers are not wage-earners employed by a big employer but they are their own masters working as independent producers on a small scale The average Indian peasant is an independent producer working on his own account, and not a wage-earner employed by a master ; and there are multitudes of these small producers in the Indian handicrafts and cottage industries There are also millions of wage-earners in India, but they form a much smaller proportion of the population in India than in England or the United States

So there is a measure of truth in Sir T Morison's statement "The rate of wages is a matter of very slight concern to the working class of India" (Indian Industrial Organization)

(2) Some writers use the expression *wages in a wide sense to mean the price paid for the services of labour* And by labour they include *all the various kinds of personal services*, for which a payment is made The word "Wages" in this sense means the earnings of labourers hired by the entrepreneur, the earnings of the entrepreneur himself for his labour of superintendence, the earnings of professional men, the salaries of salaried employees etc

The entrepreneur for his own labour of superintendence gets an income called the wages of superintendence So the term wages is applied not only to the income of labourers hired by the entrepreneur, it also used to mean a part of the income of the entrepreneur himself

Real and Nominal Wages

The *real wages* of labour are the remuneration of the labourer reckoned in the necessaries, and conveniences of life that are given for labour The *nominal wages* of labour consist of the quantity of money paid

Prof Marshall quotes Adam Smith "The *real wages of labour* may be said to consist in the quantity of the necessaries and conveniences of life that are given for it (labour) *its nominal wages* in the quantity of money The labourer is rich or poor, is well or ill rewarded, in proportion to the real, not the nominal wages of his labour"

And Marshall goes on to point out that the words '*that are given for it*" must *not* be taken to apply *only to the necessaries, conveniences that are directly provided* by the purchaser of labour or its products , for account must be taken *also* of *the advantages which are attached to the occupation and which require no special outlay on his part*

Two labourers earning the same nominal wages may have very unequal real wages

In calculating the real wages of an occupation at a particular time and place we have to allow for (*a*) *variations in the purchasing power of money* We must pay special attention to those things on which the class of labour in question spends most of its wages

(*b*) Allowance also must be made for all *trade expenses* The net income of the barrister (or of the doctor) is his gross income

minus his trade expenses like the salary of a clerk, the cost of keeping a carriage etc

( ) We must allow for the *certainty* or *uncertainty of success* and the *regularity or irregularity of employment* in the occupation

(*d*) We must take into consideration opportunities which the surroundings afford, of any *supplementary earnings* for the man engaged in the occupation or for other members of his family

(*e*) Allowance also must be made for *varieties in the form of payment* as when certain quantities of food and drink or the rent of a cottage etc are given by the employer to the labourer in addition to the money wages

(*f*) *The longer duration of labour power* in some occupations in some countries must also be taken into account If two labourers work at the same nominal wages in two occupations, that one receives the higher real wages who lives longer than the other

We must also take into consideration that one occupation is healthier than another, or that it gives a better social position, or that it is more or less dangerous to life and limb, or it offers chances of high rewards to some members of the occupation, and so on

The attractiveness of an occupation to a labourer, depends not upon money wages but upon the real wages, the net advantages of the occupation

In comparing the relative prosperity of labourers in different countries, we have to compare not their money wages but their real wages Money wages may be the same in two countries, but real wages may be higher in one country than in the other, and the labourers in the country with higher real wages will be better off

Prof Seligman uses 'real wages' in a somewhat restricted sense "Money wages are actual wages paid in money ; real wages are actual commodities that the money wages can buy" He seems to exclude other advantages attaching to the occupation

Time wages, piece wages, efficiency earnings

The earnings or wages of a person in any given time, such as a day, a month or a year constitute his *time wages* or time earnings

We have a system of *piece work wages* when wages are paid in proportion to the quality and the quantity of the work done by the labourers

Wages paid in proportion to the ability and efficiency required of the labourer are called *efficiency earnings* or efficiency wages In the words of Prof Marshall "The tendency of economic freedom and enterprise to cause everyone's earnings to find their own level, *is a tendency to equality of efficiency earnings in the same district*"

Wages and cost of labour to the employer

For the employer *low waged labour which is inefficient is really dearer than high-waged labour which is efficient*

This is the economy of high wages and its truth is very well realised by shrewd business men all over the world and specially in America. A simple illustration will make the thing quite clear *To the employer cost of labour is high or low according as he gets a small or large return for the wages he pays* One labourer earns one pound a week and produces goods worth two pounds Another labourer earns a higher wage viz, two pounds a week but he produces goods worth 5 pounds Surely it is the labourer with the higher wage, who is cheaper to the employer because for each pound of wages which he gets from the employer, he gives to the employer a larger product than the low waged labourer

An average labourer in an Indian cotton mill receives wages per day much lower than an average labourer in an English mill, but the low efficiency of Indian labour makes the cost of labour to the employer higher in India than in England

Of two labourers one earning a high wage and the other earning a low wage, on account of the difference in efficiency (and both using the same quantity of machinery,) the high waged labourer is cheaper to the employer because he does a larger amount of work for the employer with the same quantity of machinery

Some peculiarities in connection with the demand and supply of labour

Prof Marshall notices the following peculiarities in the action of the forces of demand and supply with regard to labour which are of great importance in the theory of wages

(1) *The worker sells his work but retains property in himself,* (he does not sell himself like a commodity or any material agent of production)

The investment of capital in him is limited by the means, the forethought, and the unselfishness of his parents

(2) *The seller of the labour must deliver it himself* And it is a matter of importance to him that the place where he is to labour is a healthy one, where he will have good associates and other advantages

(3) Labour is *perishable* If a labourer does not work for some days on account of loss of employment, his labour for those days is irrevocably lost and cannot be recovered

(4) The sellers of labour are generally poor, they have *no reserve fund* and they cannot easily withhold the supply of their labour from the market For these reasons, labourers generally speaking are at a great disadvantage in their bargaining with employers

(5) Another peculiarity consists in the *slowness of the growth of new supplies of labour* It takes time to prepare and train labour for its work and the returns from the training also come slowly

It is to be noticed that in these respects the position of the Indian labourer is generally much weaker than in England and other countries where labour is educated, efficient, well organized and better paid

Is there a general rate of wages ?

Economists are divided on this question The two different and opposed views are given below

(A) *There is no general rate of wages*

There are different kinds of labour and so there are different rates of wages

(i) *Carver*

There are almost as many kinds of labour as of products and it will be quite as unreasonable to find a general rate of wages for labour as to find a general price for products

(ii) *Marshall*

So also Prof Marshall "There are no such things in modern society as a general rate of wages There are as many different rates as there are occupations and each trade, profession and occupation has its own wage problem "

(B) *Seligman*

There is a general rate of wages in the sense that it varies comparatively little as between a substantial minimum for the bottom grade and a not very much greater return for the higher

grades of those labourers whose numbers are of importance. In this sense, Seligman says there is a rate of wages like a rate of interest

We use the term 'general level of prices' and we speak of the rise and fall of prices Similarly we may speak of a general rate of wages and a rise or fall in the level of wages

Theories of wages

(1) The theory of the iron law of wages

According to the advocates of this theory *labour is a commodity* Workers are the sellers and employers are the buyers of this commodity The value of a commodity is determined by its cost of production And what is this cost of production of labour ?

The cost of production of labour consists of necessaries required to maintain the worker and his family

The value of labour, (*i e wages*) *is determined by this cost of production* (*i e* the minimum necessary to maintain a labourer and his family),

This theory of wages was started by the classical school and received support from Ricardo in England, and Say in France And under the name of the Iron Law, it has been used by the Socialist Lassalle to attack the existing distribution of wealth

The theory of the iron law of wages is now rejected by scientific economists and it has been abandoned even by the socialists

The objections to this theory are clear and overwhelming—

(1) This theory cannot satisfactorily explain the inequality of wages in *different occupations*

The necessaries required by an unskilled labourer are practically the same as the necessaries required by a labourer engaged in skilled occupations like electrical engineering etc , but the wages in skilled and unskilled occupations are different The theory cannot also properly explain the inequality in wages in *different countries* or at *different times*

The amount of necessaries consumed in different countries or at different times by an ordinary labourer may be the same and yet the wages may be different.

(2) This theory takes notice only of the *supply side of* labour, *i e*, the number of labourers and it neglects the demand side

And as regards the supply side it makes the mistake of holding the view that the supply of labourers is determined simply by the necessaries of existence

(3) Again as Prof Gide points out the *theory is either too optimistic or too pessimistic*

The theory is too optimistic if it holds that wages cannot fall below necessaries of existence—in the worst paid occupations wages do actually fall below necessaries The theory is too pessimistic if it maintains that wages cannot rise above necessaries —the wages of labourers in most of the skilled occupations are much above the necessaries of life

The golden law of wages

Some people maintain that the wages of labourers belonging to a particular class are determined by the standard of living prevalent among that class As the standard of living of a class rises, the wages of thatclass would rise

Criticism

Such a theory of wages is too optimistic, it would make wages depend upon the wants of the labourer aad not upon his productivity According to this theory, the labourer has only to increases his wants to increase his wages (This excessively optimistic theory of wages is called the golden law of wages)

(2) The Residual claimant theory of wages

This theory has been developed by Walker one of the most original thinkers among the economists of America, The substance of Walker's theory is this—

The labourer is not a commodity, he is an instrument of production and the value of his labour depends upon his productivity

Wages are determined by the productivity of labour

And the wage earner is the residual claimant in distribution *He is the residual claimant in the sense that he receives all that remains of the total product when the shares of the other agents of production* (viz rent, interest, profit) *have been deducted* (Wages= total product of industry—rent—interest—profit)

Rent, interest and profit are fixed by the laws of rent, interest and profit, and as there is no law for fixing the amount of wages

to be paid, all that remains of the value of product goes to the labourers as wages

When there is no additional demand for land the rent (of land) cannot rise, when there is no additional demand for capital there is no rise in the rate of interest, when there is no additional demand for employing ability profit also cannot increase, and if under these circumstances there is an increase in the amount and value of product (due to invention of machinery or due to the improvement of organization or to quality of labour) the whole of the increased value will go to labour as the residual claimant

Walker

Wages strictly form the residual share of the product of industry, residual in this sense that it is enhanced by every cause, whatever that may be which increases the product of industry without giving to any one of the other three agents of production a claim to an increased remuneration under the operation of principles already stated residual in the sense that even if any one or all of the other agents of production become so engaged in any given increase of the product as to become entitled to an enhanced share in its distribution, their shares still remain subject to determination by positive reasons *while wages receive the benefit of all that is left over after the other claimants are satisfied*

Criticism of the residual claimant theory

(1) If the labourer is the residual claimant then combinations of labourers (trade unions) cannot raise wages because trade unions cannot increase residual shares As a matter of fact trade unions raise wages and so the residual claimant theory fails

(2) The residual claimant theory does not take into account the influence exercised by the abundance or the scarcity of labour upon the rate of wages This is a most serious omission

(3) Walker the propounder of the residual claimant theory, himself *recognises that this theory will apply to the wages of labour only under certain conditions*—he maintains that labourers will get the residual shares "unless by their own neglect of their own interests or through inequitable laws or social customs having the force of law" they are deprived of a portion of it by the other agents of production

And in actual practice these conditions are often not realised so the residual claimant theory ceases to apply to actual wages

(3) The Wages Fund theory

The wages fund theory was during fifty years (1820-1870) the accepted doctrine of English economists on the subject of wages

This theory has been much criticised and is now generally rejected

The substance of the theory is this

The total amount of wages paid in a country depends upon the amount of capital set apart for paying wages The amount of capital set apart for paying wages is the circulating capital of the country and it is called the *wages fund*

The *demand for labour* consists of this wages fund for paying labourers and the *supply of labour* consists of the number of labourers Wages, (that is the average rate of wages) depend upon the supply of and demand for labour, *wages are determined by dividing the wages fund by the number of labourers*

$$\frac{\text{Wages Fund (circulating capital)}}{\text{Number of labourers}} = \text{Average rate of wages}$$

If the wages fund amounts to 30 million pounds and if the labourers number 2 million, then the average rate of wages will be £15 per labourer

Conclusions from the wages fund theory

The advocates of the wages fund theory draw the following conclusions from the theory

(*a*) Wages can be increased only by increasing the circulating capital of the country or by diminishing the number of labourers

(*b*) If there is no increase in the circulating capital or no diminution in the number of labourers, then the attempt of one class of labourers to increase their wages will either fail or will succeed only at the expense of wages of other classes

The wages fund theory is thus very pessimistic as regards the future of the working classes And so it has been very unpopular with them even before its rejection by scientific economists

A short history of the wages fund theory

The wages fund theory was the wages theory of the English economists of the classical school for about half-a century (1820 1870)

In Malthus we find that a certain fixed proportion of the total food produce of a country (and this total produce also is supposed to be fixed in amount) is supposed to go to the labouring classes

James Mill substitutes capital for goods in his reasonings John Stuart Mill adopts his father's doctrine with some modifications and gives final shape to the wages fund theory

"Wages depend on the proportion *between population and capital* wages meaning of course the general rate cannot rise but by an increase of the aggregate funds employed in hiring labourers or a diminution in the number of competitors for hire "

Mr F D Longe's and Mr Thornton's attacks on the wages fund theory led Mill in 1869 to make his celebrated recantation and to acknowledge that he has been wrong in his statement of the theory of wages

Even after Mill's surrender, the theory of the wage fund was defended by Prof Cairnes who attempted to reply to the arguments of Longe and Thornton

The theory however completely collapsed after the attack on it by Prof Walker in "The Wages Question" He maintains that wages are in no sense determined by the proportion between population and capital and that wages are paid out of the product of the present industry and hence production furnishes the true measure of wages

Walker and certain other economists have wholly and completely rejected the Wages-Fund theory (1) they have maintained that there is no fixed wages fund and (2) and they have gone so far as to deny that wages are paid out of capital

As against these writers Taussig has attempted and with considerable success a partial defence and reconstruction of the Wage-Fund Theory He tries to prove that (1) wages are advanced out of capital (2) wages-funds in the hands of the capitalists though not absolutely fixed are roughly predetermined and yet elastic within considerable limits According to him, the wages-fund doctrine bears not on the permanent and unalterable relation of real capital to real wages but on the relations of certain kinds of labourers (hired labourers) to the capitalists of our modern communities (Taussig—Wages and Capital)

(Prof Taussig says the final word on this subject His conclusion is that there is an element of truth in the wages fund idea, but he allows a limited degree of elasticity to wages)

Criticism of the wages fund theory

(1) *Wages are not paid out of capital* they are only advanced out of capital *Wages are paid out of the product of industry Wages come from the national dividend* and the national dividend is not a fixed fund but it is a flow or income stream

The labourers by increasing their productivity will increase the national dividend and can thus raise wages without increasing the so-called wages fund

(Any other cause which increases the national dividend makes possible an increase of wages, other conditions being favourable)

(2) *The amount of capital from which wages are advanced is not rigidly fixed* as is assumed in the wages fund theory There is no fixed wages fund It is an elastic amount and it will increase with an increase in the remuneration for capital

(3) The wage fund theory implies that there a national wages fund set apart for hiring labour, and of course this national wages-fund must be a total of individual wages-funds in the hands of individual employers As a matter of fact *there are no such individual wages-funds set apart exclusively for hiring labourers and for doing nothing else*

(4) The wages fund theory makes the mistake of neglecting the fact that an increase in the number of labourers increases the product to be divided

(5) The unsoundness of the wages fund theory is also proved by the following cases

(a) If the wages fund theory were correct then wages would necessarily fall after a war on account of the destruction of capital and the consequent decrease in the national wages fund But actually wages do not always fall after the end of a war

(b) Again if the wages fund theory were true, wages would always fall after the end of a crisis which destroys part of the national capital Actually, however, this does not always happen

(c) According to the wages fund theory wages would be low in a new country with its smaller accumulation of capital, than in old countries with their larger supplies of capital We often find, however, that wages in new countries are higher than in old countries

(d) Again strikes often increase the wages of labourers without in any way increasing the wages fund

Such cases which cannot be explained by the wages fund theory and which are arguments against the theory can be multiplied

Mill's two propositions relating to capital which support the wages fund theory and Marshall's examination of them

(1) One proposition is that *industry is limited by capital* From this *Mill argues that industrial activity independent of the growth of capital cannot raise the rate of wages* In answer to this, Marshall says that the proposition that

industry is limited by capital can be explained so as to be true but a similar explanation would make the statement that capital is limited by industry equally true (This proposition is used by Mill to show that since protection cannot increase capital and since industry is limited by capital therefore protection cannot increase industry The cause of free trade however does not need the support of such a weak argument, it is strong enough in itself)

(2) Another proposition of Mill is *demand for commodities is not demand for labour* Marshall says that this proposition expresses Mill s meaning badly The proposition may mean two things

(a) It is not always true in the sense that the direct hire of labour is more beneficial to the labourer than to spend it on buying commodities

(b) It is true in the sense that if a consumer of ready made articles becomes a producer and an employer of labour and postpones his own consumption of capital and pays wages with it then he does some good to the labourers But the same postponement would have resulted in the same benefit to labour if the purchaser had made no change in the mode of his expenditure

(4) Demand and supply theory of wages

The price of labour depends upon the demand for and the supply of labour The employer's *demand for labour* depends upon the marginal productivity of labour (the net product which the marginal labourer contributes) *The demand price for labour is governed by its marginal productivity* (See general theory of distribution page 144)

The *supply of labour* depends upon the number of labourers and also the efficiency of labour

The total supply of labour may be increased, either by increasing the number of labourers or by increasing their efficiency or by increasing both The factors which regulate the efficiency of labour are comparatively simple but the factors which regulate numbers are more complex and vary somewhat In considering the question of numbers, we have to consider the general law of population It is the *standard of living*, which chiefly determines the rate of growth of population in rich and progressive countries and the standard of living means the number of other wants whose satisfaction the individual considers of more importance than marriage or family The standard of living may be said to influence wages just as the cost of production of a commodity influences its price by limitation of the supply

The standard of living affects the supply of labour, (1) partly by increasing the age for marriage and by restraining the increase of numbers and (2) also by increasing the efficiency of labour. (A rise in the standard of living for workmen increases their efficiency because such a rise means better and more plentiful food, clothing and house accomodation for these workers, and also larger leisure and improved opportunities for education Other things being equal, a restriction in the size of his family enables the work man to maintain a high standard of living for himself and his family but with high productivity of labour as in a new country the workman is able to maintain a high standard of living even with a large family, and his growing sons are great helps and not hindrances to the settler in the rich soil of a new country)

In the long run, a rise in wages generally increases the number of labourers and also increases efficiency by raising the standard of living A fall in wages reduces the number of labourers and also reduces efficiency . The rate of wages that is sufficient to attract a certain quantity of a particular kind of labour is the *supply price* of that labour.

When the demand and the supply prices of labour of a particular kind are the same, we have an equilibrium of demand and supply and an *equilibrium rate of wages*.

Mobility of labour

The supply of labour is adjusted to the demand for it by the mobility of labour This mobility consists (*a*) in the movement of adult labourers from one occupation to a more profitable occupation (*b*) in the growth of new supplies of labour from the children of labourers who grow up to manhood

Vertical mobility means the power of labour to move from one industrial grade to another *Horizontal mobility* means the power of labourers to move from one occupation to other occupations of the same grade There is only a small degree of vertical mobility , but the amount of horizontal mobility is already very considerable and it is increasing on account of the increasing diffusion of education and the breaking up of the barriers between different trades through the introduction of machinery

Taussig's theory of wages

Prof Taussig says "The simplest and clearest mode of stating the theory of general wages is, in my judgment to say that *wages are determined by the discounted marginal product of labour*"

Now the expression *marginal product* is obvious enough But what is *discount?* Discount implies an advance Production under modern round about methods takes time, and the labourers are maintained during this period by advances from capitalists

The capitalist employer advances to the labourers as wages less than what the labourers eventually produce, the capitalist employer discounts the product of labour, and thus makes his gain

The practical man readily sees that the labourer cannot be paid as much as the product will sell for, otherwise nothing will be left for the employer and the capitalist *And at what rate will the future product of labour be discounted?* Taussig says that normally the rate of discount is the *current rate of interest and the current rate of profit* for that particular kind of business and *the product of labour being thus discounted will give the rate of wages*

Criticism of Taussig's theory

Prof Taussig himself anticipates and attempts to answer the two following objections to his theory

(1) *The doctrine* that wages depend upon the discounted marginal product of labour *is a dim and abstract one*, remote from the problems of real life

(2) If we argue that the rate of interest depends upon the excess of what the labourers produce in the future over what is advanced to them in the present, the rate of interest would then *result* from the process of advances to labourers, it could not also regulate or determine the amount of these advances *The theory thus involves the risk of arguing in a circle*

(3) A third objection is this Taussig like Walker makes the labourer a residual claimant The labourer gets what is left of the product of labour after deducting interest and profits at the current rates The shares of the capitalists and employers are determined by certain fixed laws and whatever remains of the product of industry goes to labour as the residual claimant The criticism of Walker's residual claimant theory applies to the theory of Taussig

Different rates of wages in different occupations

Other things being equal, *wages in different occupations are proportional to the efficiency and exertion required in each of them In each occupation*, the wages of the labourers depend upon the relation between the demand for such labourers and the supply of such labourers and upon the relative bargaining strength of the labouring class and the employing class

There are special considerations to be borne in mind in any attempt to explain the differences of wages in different employments

Some causes of differences of wages in different employments are the following

(1) *Agreeableness or disagreeableness* of the employment Other things being equal, an agreeable occupation would command a lower rate of wages than one not agreeable

(2) *The ease or difficulty of learning it* and also the *expense of training* Other things being equal, an occupation requiring expensive training tends to have a high rate of wages

(3) The *regularity or irregularity of employment* Irregularity of employment has to be compensated by high wages when employment is available

(4) *Certainty or uncertainty of success*

(5) *Supplementary earnings* and any *incidental advantages* like gifts of food and drink or rent free houses etc (6) Social advantages or disadvantages (7) whether the employment is a healthy one or not, whether it is dangerous or not In dangerous employments, wages are generally high

In other words *the attraction of an occupation lies not in its money wages but in its net advantages*, and low money wages may be compensated by other advantages

Mobility is an important factor Other things being equal, efficiency earnings tend to be equal in different occupations when there is perfect mobility Want of mobility produces differences in wages for the same kind of work in different occupations The wages in certain occupations (*e g* wages of the doctor or of the solicitor) are very high because of this absence of mobility The masses of the people are prevented by economic and social conditions from entering these occupations in any considerable numbers and so the earnings remain high Wages also are high when the numbers in an occupation are artificially restricted by combination among workers

Prudent men when choosing occupations for themselves or for their children should look not only at money wages, but also at other advantages and disadvantages of different occupations—they should attach a proper degree of importance to the expenses of training for the occupations, regularity of employ-

ment in it, chances of success, whether the work is agreeable, healthy, safe, supplemental earnings and also social advantages When occupations otherwise suitable and profitable are rejected only on grounds of sentiment and social prejudice by a man choosing an occupation for his son, the son is injured economically and the nation also suffers If the occupation of a lawyer is chosen for their wards by many fathers on grounds of social prestige, the profession is overstocked, the earnings are low on an average for the members , and there is a great loss to the nation through the wasting of many young men with their abilities and energies frittered away which might have been much better used for themselves and their country

An evil paradox

It has been seen that generally speaking the more disagreeable the occupation, the higher the rate of wages We have however the evil paradox that *the dirtiness of some occupations is a cause of the lowness of the wages paid in them* and the reason is this The employer finds that to have his work performed by skilled men with proper appliances he will have to pay a high rate of wages on account of the unpleasant nature of the work So he has the work done by low grade labourers, who are not worth much to any employer and who earn very low wages And the numbers of such labourers are generally large and their mobility is small and thus their wages are kept from rising

† Low wages of women

One very noticeable thing about the wages of women is that the wages of women are generally lower and often very much lower than the wages of men Women's wages are in many cases insufficient to maintain a woman even if she is alone and they are good enough only as an auxiliary wage to supplement the family income It has been calculated that in 1912, the average wages for an adult workman in England amounted to £1-5s-9d per week, and the average wages for an adult working woman amounted to less than half this sum

The low wages of women constitute one of the grave social problems of the day

† Mill's treatment of this subject though old, still retains much of its interest and indeed has been hardly surpassed (Principles—Book II)

The causes of low wages of women

(1) One reason generally advanced is that women are in most cases less productive than men But this is not, however, always the case ‡

(2) It is said that a woman has a lower level of subsistence and fewer needs than a man Moreover a man has to earn enough wages to maintain himself and his family whereas the wages of a woman go generally to maintain only that woman These things depress women's wages

But many women workers have to support not only themselves but also dependents——in England these women workers with dependents to support form about two-third of the whole So the low wages of women cannot be explained adequately in this way There are other causes

(3) Women generally occupy non-competing groups relative to men They are prevented by custom, lack of training, trade unions from entering many skilled occupations in which men earn high wages, and in the occupations which are resorted to by women, excessive competition among themselves brings down the rate of wages

The low wages of women even when they are doing the same kind of work as men, or work requiring the same exertion——low wages of women under these conditions are due (a) partly to the lower subsistence level of women, and the fact that some women have no dependents to support (b) and largely to the lack of organization among women workers Women are badly organized and so are forced to accept lower wages than men

Rise of Wages

During the past century, there has been a gradual increase of wages And this is proved by the statistics of wages from almost all countries As regards this rise in wages, certain things must be borne in mind

(1) This increase of wages is partly nominal and due to the depreciation of money Still there has been a considerable increase of real wages because money wages have risen faster than the increase in the cost of living

‡ Mrs Fawcett quotes satisfactory evidence which goes to show that at least in many war industries the allegation about the inferior productivity of women is without foundation (Afterwar Problems)

(2) The increase in the real wages of the labouring class has not, however, been in proportion to the growth of wealth of the other classes of the society

The problem of unemployment has become a chronic evil of the present economic system and remedies for this are urgently required

The War has brought about in England and other belligerent countries a great rise of prices and also a great increase in wages The increase in money wages is due (i) partly to monetary causes (*i e* depreciation of money) and (ii) in part to the high demand for labour in war industries, and the deficient supply of labour

THE WAGE SYSTEM

Advantages and Disadvantages

Advantages —

(1) The enterpreneur has full control over the business and this makes for efficient production

(2) It secures for the labourer a definite and fixed income whether the business turns out a success or a failure

These advantages of the wage system have made it dominant in the modern organization of industry

The liberal school looks on the wage system as a permanent one and the only improvement it suggests is to make the labour contract more free and deliberate, and organized on the part of both the labourers and the employers

Disadvantages

(A) *Socialistic criticism*

The socialist school sees in the wage system simply a historical category, the third stage in an evolution of which the first two stages were slavery and serfdom

The socialists criticise the wage system and point out the following defects

(*a*) The dependence of the labourer upon the employer

(*b*) The deduction of interest and profits from the product of labour and at the expense of the labourer The socialists

recommend the abolition of the wage system along with the system of private property

(B) *Criticism by co-operators*

The co-operative school also regards the wage system as a temporary one to be re-placed by a better system in future They point out the following real defects characterising the wage system

(1) The conflict of interests between the employer and the employed, one trying to give the minimum wage for the maximum labour and the other trying to give the minimum labour in exchange for the wage received

(2) The labourer getting a fixed rate of wages has no incentive to do his best and so the efficiency of production seriously suffers The remedy suggested by the co operators is co-operative production

Wages

Summary

1 The expression 'wages is used in a wide sense to mean the price paid for the services of labour

2 The '*real wages*' or labour (*i e*, the necessaries and conveniences of life that are given for labour) are to be distinguished from the *nominal wages* of labour (*i e*, the quantity of money paid) In calculating real wages, allowance has to be made for variations in the purchasing power of money, trade expenses, certainty of success, regularity of employment, supplementary earnings, varieties in the form of payment, duration of labour power and other things

3 *Theories of wages*

(1) *The theory of the iron law of wages*—wages are determined by the minimum necessary to maintain a labourer and his family *Objections* (i) This theory cannot explain the inequality of wages in different occupations in the same country, also in different countries or at different times (ii) it neglects the demand side of labour (iii) it is either too pessimistic or too optimistic

(2) *The residual claimant theory* The labourer is the residual claimant in distribution, and his wages equal the product of industry *minus* rent, interest and profits determined according to the laws of rent, interest and profits *Objections* (i) The theory is inconsistent with the well known fact that combinations of labour can raise wages (ii) it neglects the supply side of labour (iii) and by Walker's own admissions it applies only under certain conditions and these conditions are rarely if ever realised

(3) *The Wages Fund theory* Wages are paid out of capital The average rate of wages is determined by dividing the fixed Wages Fund (circulating capital) by the number of labourers

Objections (i) Wages are advanced out of capital, but they are ultimately paid out of the product of industry, and the product of industry can be increased by increasing the productivity of labour and in other ways (ii) There is no rigidly fixed national wages fund, and no rigidly fixed individual wages funds (iii) An increase in the number of labourers increases the product to be divided

(4) *Demand and supply theory of wages* Wages are determined by the demand for and the supply of labour The equilibrium rate of wages is the rate which equates the demand and the supply

(5) *Taussig's theory* Wages are determined by the discounted marginal product of labour

4 Differences of wages in different employments are due to differences in the efficiency and exertions required in them Other causes of these differences in wages are (1) agreeableness or disagreeableness of the employment (2) ease or difficulty of learning it, also expense of training (3) regularity or irregularity of employment (4) certainty or uncertainty of success (5) supplementary earnings, and other incidental advantages

Marshall has pointed out that the dirtiness of some occupations is a cause of the low wages paid in them

The wages of women are generally much lower than the wages of men This is due (*a*) partly to the low productivity of women (*b*) partly to their lower subsistence level (*c*) and also to excessive competition among women in certain occupations

Questions

1 What different meanings are given by economists to the word 'wages'? Are the earnings of the entrepreneur for his labour of superintendence 'wages'?

2 Distinguish between 'real wages' and 'nominal wages' How are we to calculate the 'real wages' of labour in an occupation?
Write explanatory notes on time wages piece wages and efficiency earnings

3 In estimating the relative prosperity of labourers in different countries, is it sufficient to compare money wages? (C U 1914)

4 Enumerate some peculiarities in the action of the forces of demand and supply with regard to labour (1910 II)

5 Give a short account of the demand and supply theory of wages

6 Explain and briefly examine Lassalle's Iron Law of Wages

7 What is residual share in distribution?

Expound the residual claimant theory of wages as put forth by Walker (1909)

Notice the objections which have been advanced against the theory,

8 Give some account of the Wages fund theory and the controversies associated with it (C U 1911, 1915 H)

9 'Wages have been described as the discounted product of industry' Bring out the meaning of the phrase and consider whether it is a correct explanation, (C U 1915)

10 Give briefly the causes of differences of wages in different employments (1915 H)

11 How would you account for the low wages paid to women? (C U 1915)

CHAPTER IV

LABOUR PROBLEMS

Trade Unions

A Trade Union has been defined as "a continuous association of wage earners for the purpose of maintaining or improving the conditions of their employment (Sidney and Beatrice Webb in History of Trade Unionism)"

We may notice three distinct types of labour organizations

(1) The *Trade Union* representing a combination of wage-earners in a single trade or two or three closely related trades An association of locomotive engineers all engaged in the same trade is a strict trade union

(2) The *Industrial Union* composed of all kinds of wage earners in a given industry A given industry generally includes many trades, all railway workers including locomotive engineers, guards, station staff may form one industrial union for the whole railway industry

(3) Then there is the mixed *Labour Union* composed of wage earners from many trades and many industries

The trade and the industrial unions are more homogeneous than the mixed labour union, and are therefore more efficient though narrower and more selfish in their aims and policies

The disadvantages of labour in bargaining and how they are reduced by Trade Unions

The labourer bargaining individually with his employer suffers from the following disadvantages

(1) His labour is a perishable commodity (2) He has little or no reserve funds and so he cannot wait and therefore he will have to accept the terms dictated by the employer The employer has reserve funds and can wait (3) The labourer is comparatively immobile and he canno quickly find the best market for his labour

These disadvantages of the individual labourer in bargaining are overcome by *collective bargaining* through trade unions Concerted action on the part of workmen through trade unions, lessens to a very considerable extent these disabilities of the workmen These unions accumulate funds, which enable workmen to hold out and wait in the process of bargaining They also reduce the immobility of labour, they have information bureaux and competent officers who give the required information to the labourers and enable them to find the best market for their labour and the employer has to deal not with one workman alone but all—and so he comes to feel that the workmen are as needful to him as he to them

Two aspects of Trade Union activity

These are (1) the fraternal aspect (2) the militant aspect

(1) Fraternal functions

As a fraternal organization, the trade union seeks to accomplish some of the ends and objects of the old gilds It insures the member against accident or death, it maintains him when he is ill or when he is out of employment and also confers other benefits The older unions in England give a large number of benefits They provide *sick, accident, superannuation and funeral benefits* and they also give *out of work pay* to any member who needs it through no fault of his own They hold also meetings and lectures and exert themselves seriously to diffuse *education* and culture among the members

(2) Militant functions

More important are the militant functions of the Trade Union, through which it seeks to promote its industrial power and to increase the earnings of its members Its activities in this direction

can be reduced two categories (a) the attempt to standardise conditions of employment (b) and the endeavour to restrict work The Trade Union tries to secure a standard rate of pay and a normal working day The attempt to curtail the hours of work is really an attempt to raise the standard rate of pay.

Trade Unions and Wages

Have trade unions any influence upon the rate of wages in a particular trade and have they any influence on general wages? This is a question, which has led to great difference of opinion and controversy in the history of economic thought

Half a century ago, the general opinion among economists was that trade unions could have no effect on wages while the trade unionists maintained that a rise in wages was due to the activity of trade unions

The economists of the present generation hold a view on this subject, considerably different from that of the early economists

(1) General wages

(a) *Trade unions claim that they prevent economic friction from working against the labourer* If in any trade, wages tend to settle below the marginal worth of labour for the time being, the trade unions can at least raise wages up to the marginal productivity of labour, without causing any displacement of labour

They reduce the disadvantages of labour in bargaining and thus help towards securing fair wages (i e the current or market rate determined under the conditions of fair competition)

(b) Again some trade unions increase the efficiency of labour Strong trade unions have comparatively high standards of diligence, regularity and good workmanship and thus increase the efficiency of labour, *by increasing the marginal productivity of labour in this way, they help to raise wages*

Any other ways, in which trade unions will increase the marginal productivity of labour will tend to raise wages

Conditions under which Trade Unions may permanently raise general wages

Prof Marshall gives the following conditions under which Trade Unions will be able to raise wages permanently

The power of trade unions to raise general wages by direct means is never great The trade union by co-operating with general economic

forces which make for an increase of wages may raise wagse permanently and under the following conditions

(1) Trade unions must aim at making business easy and certain (this is already done to some extent by boards of conciliation in certain trades)

(2) The union must aim at raising the standard of life among the workers by fostering habits of sobriety and honesty, independence and self-respect.

( ) They must help as many as possible of the rising generation to acquire industrial skill and to join the higher paid ranks of labour

(4) They must try to develop the great stores of business power and inventive resources that lie latent among the labouring classes This would increase the national dividend and would make possible higher wages

(5) They must also specially be careful to avoid action, by which one class of works inflicts a direct injury to others (Workers of one class often injure other classes of workers by curtailing the supply of their raw material or by throwing them out of work through a strike in which they are not interested)

Wages in a particular trade

A trade union can raise wages in a particular trade by restricting the supply of workmen in that trade Limit the supply of workmen in a given trade and the chance is increased for getting higher wages in it If the union is strong enough to stop the influx of labour into the trade, then it will be able to raise wages, other conditions being favourable

The conditions under which a trade union can increase wages greatly by restricting the supply of labour in a trade are thus given by Prof Marshall

(The conditions under which an artificial scarcity of labour in a trade can raise wages much in that trade)

If the workers in any trade by combining in a strong trade union are able to limit artificially the supply of their labour, they can secure a considerable increase of wages, which will be the greater the more fully the following conditions are satisfied

(1) That there is no easy alternative method of obtaining the commodity which their trade helps to produce

(2) That the commodity is such that its price will be raised considerably by a stinting of supply (or in other words, the demand for it is not very elastic)

(3) That their wages form a small proportion of the total expenses of production of the commodity (and so a great rise in wages will not greatly increase the price of the commodity and diminish the demand for it)

(4) And that the other classes of workers and employers are squeezable and are not in a position to increase their share of remuneration by limiting artificially the supply of their labour and capital

Advantages of Trade Unions

We may now summarise the advantages of Trade Unions (1) Trade unions help to keep up wages to the marginal worth of labour, and trade unions help to increase the marginal worth of labour by raising the standards of efficiency and workmanship, and thus bring about a rise in wages

(2) By their collective bargaining, the trade unions are also able to better the general conditions of labour, to obtain a shorter working day, better sanitary conditions, better treatment etc.

And the march of reform is made easier for employers when at each step all competitors are kept in line by the activity of the trade unions

(3) We must also include the benefits resulting from the fraternal activities of the trade unions

Sick, accident, and super-annuation benefits and the out-work pay, paid by these unions must be noted, and the promotion of social intercourse, education and culture and the raising of the standard of life brought about by trade union activity are very important gains

Injurious effects of trade union action under certain circumstances

Trade unions acting selfishly or unwisely directed may and do injure different classes of the community

(1) By limiting artificially the supply of their labour in a particular trade, a trade union, may under certain circumstances, injure other classes of labourers, and employers, engaged in the same trade

(2) Trade union demands which needlessly injure the employer and disturb production may lead to the *emigration of capital* to a foreign country and thus bring about a *loss of employment and reduction of wages* Thus the labourer suffers and also the industrial prosperity of the country as a whole

Strikes are sometimes necessary but unnecessary strikes injure the industries of the country, cause unnecessary losses to the

employers, to labourers and to capital and sometimes make trade go out of the country

And the policy of restricting output often followed by trade unions is a wrong and short-sighted policy, it lowers the marginal productivity of labour and thus in the long run will bring about a reduction in the wages of labour

History of Trade Unionism

England has taken the lead as regards the trade union movement The principal object of the original trade unions at the beginning of the 18th century was to secure the better enforcement of various protective laws such as the statute of apprentices

Trade unions at first were not recognised by the law In 1824 the repeal of the combination laws made the membership of a trade union cease to be a criminal offence and an act of 1871 gave trade unions their present status

The position of Trade Unions has been further strengthened by subsequent legislation

New and Old Unionism in England.

We must distinguish between the old unionist movement and the new unionism The old unions discharge two main functions—protective and benevolent Those that exist primarily for protection against employers resort to strikes when necessary and those who make the provision of benefits their main concern are more unwilling to resort to strikes, because strikes will reduce their funds for giving benefits

Many trade unions started in recent years have somewhat different aims and objects from the older trade unions A new type of unions has sprung up specially in the unskilled trades The new unionism is more aggressive, more willing to resort to strikes, it generally regards provident funds as an encumbrance leading to an unenterprising and over cautious policy And these New Unions favour a large participation in politics with the object of influencing legislation in favour of the working classes

English trade unions have played a very patriotic part during the war, and for the period of the war have suspended many of their rules and restrictions

The latest development in English trade unions is a strong movement towards the policy of '*direct action* (i e direct industrial action by general and widespread strikes etc) for winning their economic and political objects ———— this being due to the loss of faith in political and parliamentary action for achieving their ends

Up to the present there is no serious and organised trade union movement among Indian labourers

Labour organizations—their methods.

The two chief methods of labour organizations are

(1) *The Strike*

(2) *The Boycott*

These are the methods by which the labour organizations seek to realise their objects

The Strike

What is the strike? A strike is a cessation of work resulting from an agreement on the part of a body of workmen, the object being to compel employers to accept the demands of the workmen *It is thus a method of industrial war*, war between the workmen and the employer, and the object is to obtain from the employer by force what cannot be obtained otherwise

The right to strike has been only grudgingly conceded, and the legality of the strike is now recognised in all modern states

Strikes

(A) Evils of strikes.

The strike is a destructive agency and as such it is bound to produce various evils

(1) The labourers themselves lose their wages on account of the stoppage of the work

(2) The employers and the capitalists are also injured by the cessation of production brought about by the strike Their capital and organization remain idle

(3) Frequent strikes may cause such disturbance to industry and such trouble to the employer that capital may migrate to other countries to find employment there

(4) The disorganization caused by frequent strikes may enable foreign competitors to gain a footing in the country

(5) In most cases, the consuming public is very seriously inconvenienced by the action of the strikers

This is specially the case with strikes in important public industries like railways, street lighting, water supply in towns, post office etc

The strike though an evil and a serious evil in certain respects, is often a necessary evil It is not always due to the fault of the workmen, it is often due in a larger measure to the faults and failings of the masters themselves

(B) Advantages claimed by the workmen

The leaders of the working classes claim the following advantages as resulting from strikes

(1) *Strikes increase the solidarity of the trade unions* and encourage the members to make sacrifices for the common good

(2) Through strikes the workmen acquire confidence in themselves and trust in one another, the masters are taught respect for their men and a reasonable fear of them And in this way strikes help the workmen to *raise their wages to the marginal productivity of labour and to get better conditions of employment and better treatment from the masters*

Strikes and Wages

When the wages fall below the marginal worth of labour because of economic friction, organization among employers, custom etc, strikes help to raise wages to the marginal productivity of labour

One successful strike may send wages up in many industries

Besides the ever present fear of strikes in the minds of the employers acts powerfully in the direction of keeping up wages

Even an 'unsuccessful' strike is not wholly unsuccessful, it may make employers more moderate, conciliatory and considerate, as they recall the anxieties, the struggles and the sacrifices of the conflict

Conclusion

Under the present circumstances, the strike is the ultimate weapon of the labourers against the employers, and so long as more peaceful methods prove to be inadequate, *strikes are unavoidable* All modern states recognise this and so have legalised strikes—strikes are no longer illegal

In certain cases however the strike is so dangerous for public security that *its prohibition has been advocated* in these particular cases

(1) First of all there is the case of functionaries and employees of the state

(2) Then there is the case of certain enterprises (the water supply, the lighting of the streets, the railway service) the interruption of which may be exceedingly harmful to public security and welfare

Trade unions and strikes

The question has been asked as to *whether there is any necessary connection between Trade Unions and Strikes* As Walker points

out some of the greatest strikes specially in the early part of the labour movement have occurred without the agency of organized Trade Unions and there have been Trade Unions which have seldom or never resorted to strikes A very recent development consists of *unauthorised strikes* in England and elsewhere, strikes not authorised by the regular trade union organizations

So it is a great mistake to regard the strike as the sole and essential function of the trade union In the words of a distinguished economist, a well-organized union wins the day without strikes, as a good general gains victories without battles

If the Union is a strong one and if its demands are reasonable it will have its demands accepted by the employers, who will respect and fear the Union, and so the Union will not be generally under the necessity of declaring a strike

In many cases the Trade Unions have, however, resort to strikes, these being due either to the unreasonable demands of the workmen or unreasonable opposition on the part of the employers or mutual misunderstanding

The Boycott

A second method used by the Trade Unions is the Boycott or attempt on the part of the workmen to induce third parties to abandon business dealings with the employers

Syndicalism

Syndicalism has a complete social programme of its own It wants to organize the conflict of the classes and to obtain *directly* (*i e* without applying to existing governments) all the rights necessary for working classes by means of single strikes or if need be by the general strike The working classes are to achieve their economic salvation by their own action as organized into unions, by what is called 'direct action' and not by looking to any help from the state or from social reform

Syndicalism is a mixture of Trade Unionism and Anarchism From Trade Unionism, Syndicalism has taken the idea that working-class salvation is to be found not in politics (and parliamentary government as at present constituted) but in self-help and self organisation through Trade Unions——the syndicalist state is to be organised largely by occupations, the workmen engaged in the same trade managing the trade for themselves From Anarchism, Syndicalism has got a deep conviction in the moral value of a revolt The syndicalists hold that a general strike might bring on the revolution, in fewer days than the decades which politics and political agitation require

This movement is powerful in France, in Italy, in the United States where the Syndicalist movement consists of a Trades Union known as the Industrial Workers of the World Recently it has also got some hold in Britain

Labour Legislation

Labour legislation by the state has the same object as trade unions, it wants to standardise the conditions of employment, and to prevent the employers from oppressing labourers by taking advantage of the bargaining weakness of labour

Labour legislation on behalf of the labourer has assumed three principal forms dealing respectively with—

(1) the conditions of employment

(2) the conditions of remuneration

(3) the results of employment

Factory Acts

These Acts in all modern countries (including England, France, U S A, Japan and even India) deal with the abuses in the conditions of employment of labour and try to remove them

(*a*) The earliest form of factory legislation was the *prohibition of child labour* Children below a certain age are not to be allowed to work (b) The second form of factory legislation is the *regulation of the hours of labour* The regulation of hours of labour was enforced first as regards children, then was gradually extended to minors, and to women and finally to adult males (*c*) The *third form of factory legislation is protection of life, limb and health* Factory Acts require the fencing-in of dangerous machinery, the establishment of proper sanitary conditions in factories and strict regulation of the so-called dangerous trades

All modern states have factory acts England is the original home of factory legislation and its example has been followed by all civilised countries

Arguments against factory legislation

The economists of an earlier generation opposed factory acts and this opposition brought them into disrepute with statesmen and men of affairs and also with the working classes The usual arguments advanced by opponents of factory legislation are given below

It will be found that these arguments are unsound and do not possess weight

Factory Acts interfere with liberty

(1) *The regulation of conditions of employment* interferes with the freedom of contract and *violates the liberty and natural rights of the employers and also the employed* (This argument has to be rejected Restrictions whenever necessary in the interest of the welfare of the labouring classes should be imposed and no fancied theory of natural rights should be allowed to stand in the way)

Factory Acts unnecessary as the labourer is able to protect himself

(2) Some have maintained that labourers are quite able to protect their own interests and the interests of their family and children without any state help in the shape of factory acts (This is contradicted by the plainest facts of experience In all countries labourers have been found unable to protect themselves without the help afforded by factory acts)

Factory Acts diminish output and thus injure business and wage-earners

(3) It has been also said that state interference with industries through factory acts reduces output and thus injures society The reduction in output also diminishes the profits of business men, discourages capital and enterprise, brings about a fall in wages

In answer to argument (3), it may be urged—

(*a*) On the whole, factory acts have helped to increase output rather than to diminish it and this is due to the increased efficiency of the labouring class, greater intensity of work and better organization

(*b*) And even if there was some loss of output it should be borne in the larger interest of the working classes and society as a whole The increase of output is not and should not be the only end to be kept in sight

Arguments in favour of factory legislation

(1) *Moral considerations*

Moral considerations demand factory acts for the protection of the working classes

The moral ideals of the present age demand that the sufferings of fellow men, women and children in factories should be removed The main force underlying and bringing about the mass of labour legislation all over the civilised world is the religion of humanity which wants to make life happier for all

(2) *Economic considerations*

Factory Acts help to increase output

A smaller number of hours of work and better conditions of work increase output by leading to greater intensity of work, higher efficiency of the worker and better organization. This is found to be the case by actual experience in different modern states.

And safeguard the industrial future of the race

(3) To permit child labour below a certain age is to stunt the growth of the child, body and mind. This and improper conditions of work for women will bring about the progressive deterioration of the working population which will seriously injure the industrial future of the country, and so these things must be prevented by suitable legislative measures.

(4) *Political and social considerations*

They are also necessary in view of important political and social considerations

In the absence of factory legislation, the factory population will be ignorant, discontented and so a source of political danger within the state. This may breed revolutions.

The progressive deterioration of the working population in body and mind under unhealthy conditions hurts the pride of race and nationality and weakens the military strength of the State against foreign enemies. These arguments have also helped powerfully the sentiment in favour of factory legislation.

† Agencies for industrial peace

Industrial strife

The militant movements among labourers in Europe and America, the increasing hostility of employers and employed, and the losses and disturbances to the employers and the employed and to society at large from strikes and lockouts (which are methods of industrial war) have led economists and other people to consider seriously measures for reducing the causes of the strife between the employers and the employed.

It is well to bear in mind always that peace-promoting machinery is of small importance compared with a friendly spirit between the

† Pigou—Principles and Methods of Industrial Peace. Wealth and Welfare.

(1) Collective Bargaining

The practice of collective bargaining by trade unions is an important means of the maintenance of industrial peace. Where a powerful Trade Union exists and where the employers frankly recognise the Union, then strikes are not frequent.

Profit-sharing and the system of the sliding scale and other methods of linking the employed to the employers do not aim at providing a remedy for industrial disputes but at anticipating and preventing such disputes.

(2) Profit Sharing

Profit sharing attempts not to provide a remedy for industrial disputes but *to prevent these disputes in advance by giving to the employees a share of the profit from the business.* At present the entire profit goes to the business man; but if he gives a share of his profit to the workmen in addition to their wages, then it can be expected that conflicts between labourers and employers would become less frequent, and as a result of this, production would become also more efficient.

At one time, a great deal was expected from profit sharing. People thought it would solve the labour problem and would bring about general industrial peace, but profit sharing has not proved so very successful as was expected.

Advantages

The *advantages* claimed in favour of profit-sharing schemes from the standpoint of production are the following:

1 The labourers getting a share of the increased profits resulting from any extra care and interest exercised by them, they are induced to be generally more careful and industrious in their work

The result is that there is less waste of materials by the workmen machinery and other apparatus of production are better cared for, labour disputes are fewer because the labourers share to some extent the profits of the business—and in all these different ways the efficiency of production is increased The increase in efficiency leads to increase in profits, part of which goes to the employers and part to the labourers who have contributed to the increased profits by their extra care and interest

2 An increase in efficiency results also in another way The fact that extra profits are shared in by labourers attracts labourers of superior capacity and industry to the profit-sharing concerns, and efficiency in the profit sharing concerns thus becomes greater than in ordinary businesses

The difficulties of Profit Sharing

The reasons why profit-sharing has not proved more successful than it is, are the following

(1) It is disliked by labour leaders because employers often use it to weaken the Trade Union movement and to make the labourers dependent upon the employers and not upon their own organized activity in Trade Unions

(2) Profit sharing sometimes leads men to work beyond their strength and thus ultimately reduces wages

(3) The amount of profit going to the labourer is not in many cases large, and so the labourers do not take much interest in profit sharing schemes And the labourers also suspect the good faith of the employers and whether the profit-sharing is being honestly done

(4) A fundamental objection is this The *profit* that is given to the employees is created by increased care, zeal and speed on the part of these workers So it *should go to the employees as a matter of right, immediately and not at some future time as a favour from the employer*, it should be given to them on pay-day by piece rate or gain-sharing methods, and not at the end of the year as under profit-sharing schemes If paid immediately, the premium of the employee cannot be lost by unwise management or dishonesty on the part of the employer, and it cannot be lost

by the employee's death, discharge or change of employment The employers also are not satisfied They often find that the power of dismissal is a more coarse and cruel but a more effective stimulant to efficiency than a bonus to workmen from eventual profits

Taussig's conclusion about profit sharing is this "*The prospects that profit sharing will be universally adopted are nil* Even the prospect for widespread is slight"

(3) Gain sharing

The object that profit sharing seeks to achieve is better attained by the various other devices collectively known as gain sharing *Piece work* is one of the methods of gain sharing, and there are other methods

(4) Welfare arrangements

Such are schools and libraries in connection with business enterprises, gardens, play-grounds, club-rooms, good dwellings at moderate rents for the workmen, mutual aid societies and pension plans aided by the employer and other similar things for promoting the welfare of the working classes As Prof Taussig points out these welfare arrangements are "good not as solutions of the fundamental problems but as mitigations of existing evils"

(5) The sliding scale

Under the system as the price of the product rises above a certain point, wages also go up by the stages agreed on in advance and as the price of the commodity falls wages fall till they reach the minimum rate of wages previously agreed on

Under this system the employer as well as the workmen share the gain from an increase in prices and they also share the losses from a fall in prices

(6) Arbitration

Arbitration is a remedy for industrial disputes, when such disputes have occurred

Arbitration may be (*a*) *public or* (*b*) *private* Again arbitration may be *voluntary or compulsory*

Some questions (*e g* the recognition of the Trade Union by the employers, the question of the closed shop) cannot be settled by arbitration but must be fought out between the employers and

their labourers *Matters less fundamental* (wages, hours, shop conditions etc) *also give rise to disputes* between masters and men, *and these disputes can be settled by arbitration* through private boards or through public boards

Permanent private boards of arbitration are based on trade agreements between employers' organizations and labourers organizations and they are a result of collective bargaining *Public boards of arbitration* as established in France, in England and also in the United States reduce considerably the number of industrial disputes *They are commonly boards of conciliation* offering their services as mediators and conciliators and *also boards of arbitration* acting as tribunals to which the disputants can refer

Prof Ely thinks that voluntary boards of arbitration have not been very successful in the United States

Compulsory Arbitration

The question of compulsory arbitration is a complicated one *Compulsory arbitration* involves the prohibition of strikes and lock-outs and a *compulsory reference to the decision of a majority of a wages board or to the decision of a judge or an arbitrator*

(A) Difficulties about compulsory arbitration The difficulties as regards compulsory arbitration are the following

(1) The difficulty about the enforcement of the decisions given by the arbitrators if these are resisted by the labouring class or by the employer class

(2) Under compulsory arbitration, wages (and practically also interest and profits) will compulsorily be determined by a public authority, and not by competition

Compulsory arbitration supplants competition and does not confine itself to regulating the limits within which competition shall work *It is faced with the fundamental difficulty of determining what is fundamentally just in distribution*

(3) And as Prof Chapman points out——in a large industrial community wages under the system of compulsory arbitration may be for a long time thrown out of relation to the relative demands for different kinds of labour in different trades and *so the response of production to demand would be weakened*

So compulsory arbitration cannot be applied to all the industries of the nation in many countries, at least under present conditions

(B) *Compulsory arbitration wanted in certain special industries*

(i) Compulsory arbitration is however required as regards *fundamental industries* like railways, upon the regular and continued activity of which the whole community is dependent

(ii) It is also wanted in the *sweated trades* where the conditions are absolutely miserable, and the labourers are unable to improve their lot by their own efforts

Up to the present time Indian labour is unorganized and serious industrial war is absent and so there are no organized agencies for industrial peace

Unemployment

The problem of unemployment is a difficult one

Unemployment means here *unemployment among the wage-earning classes and in respect of wage-work*—it has been described as 'involuntary' idleness † of persons who have no work and of persons who are working short-time

Socialists like Marx and Rodbertus contend that a large reserve of unemployed workmen necessarily comes into being under the capitalist system, and they attempt to prove that continuous unemployment on a large scale is inevitable under present conditions

Evils of unemployment

The principal evils are (i) loss of wages to the labourers, also fluctuations in their earnings, the sense of insecurity and uncertainty (ii) the habit of regular work may be lost and self-respect and self-confidence destroyed, so that the man once unemployed, may be found to have become unemployable

The causes of unemployment

I **Internal causes**—*defects in the unemployed workmen* These are physical, mental and moral defects of the labourers causing their unemployment and these defects may be inherited or acquired, removeable or not removeable

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† Pigou-Unemployment

II External Causes

The external causes of unemployment or under-employment are (1) Cyclical movements (2) Seasonal demand (3) Seasonal supply (4) Changes in the conditions and organization of industry (5) The system of casual labour (6) Inelasticity of wage-rates

(1) *Cyclical movements*

Periods of bad trade follow periods of good trade in cyclical movements after more or less regular intervals When business is dull and stagnant when the demand for commodities is slack, employment is not available for all labourers in the community

(2) *Seasonal demand*

This varies with different seasons of the year Take the case of the coal miners—they are least in demand in the summer and so at that time many of them will be unemployed Again persons engaged in the building trade get full employment not in all seasons, but in certain seasons

(3) *Seasonal supply*

Natural causes affecting the conditions of supply limit the work to be done in certain industries, and thus affect employment

(4) *Industrial changes* which are neither cyclical nor seasonal These changes may be changes in the methods of production on the one hand, and changes in demand on the other, and they affect employment.

(5) *The system of casual labour*

The casual labour system means employing workmen *temporarily* for special jobs (instead of giving them regular and continuous work)

The result is that many more labourers are drawn into the occupation than can be regularly employed, and so there is unemployment (Casual labour is largely employed in loading and unloading freight from vessels and railways)

(6) *Inelasticity of Wage rates*

If wage-rates are rigid (because of the mutual suspicions of employers and employees) and fail to move up and down according to changes in the demand now for one kind of labour and now for another——then necessarily there will be some unemployment

Remedies

The following remedies have been suggested for reducing unemployment

(i) *The labour exchange as a remedy*

There may be at the same time unemployed labourers, and a demand for just the kind of labour that is unemployed This labour and the demand for labour can be brought together by labour exchanges

The labour exchange can be used to provide more regular work for the labourers and thus to reduce the evils of casual labour

Labour exchanges are most efficient when they are organised into a national system, and when they act not merely as bureaus of information but as centres where the labourers can be actually engaged

(ii) *Remedy for unemployment caused by trade fluctuations—government action*

One remedy is to make the public demand for labour compensatory as far as possible

† Much of the demand of the public authorities for labour can be made to vary inversely as the trade cycle, without great trouble or loss, the public demand for labour can be increased when there is unemployment and *vice versa*

(iii) *Other remedies*

(a) One is the system of spreading the diminished demand for labour over all labourers in the affected trades—so that all workmen should earn less wages per week than usual rather than some should earn nothing at all

This is only a *palliative*, and it will not abolish unemployment Labour colonies are useful (a) for the reformation of drunkards and vagabonds etc, (b) for the restoration of those who have become unemployable through physical, or mental defects

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† So far as the public authorities' demand for labour fluctuates, it is desirable to liberate such demand from the influences of good and bad trade and seasonality, and then deliberately to attempt to make it vary inversely with the demand in the open market" (Report of the Poor Law Commission 1905—1909)

The relief of the unemployed Insurance

When unemployment has actually occurred, the distress caused by it may be mitigated in the following ways

(1) The State (central government, also municipalities and local bodies) may provide work for the unemployed to relieve distress ——this is done in every country, and in India on a very large scale during times of famine

(2) Another most important thing is insurance It has been proposed to organize insurance against unemployment specially through trade unions and under certain circumstances subsidised by the state

Poverty and Poor Law

A great amount of poverty exists in every modern society

The causes of poverty are as complex as civilisation and the growth of wealth itself "The Malthusian seizes upon redundant population, the communist upon private property, the socialists upon property in means of production, the single taxer upon property in land, the co operator upon competition and so on They all forget that widespread poverty has existed in the absence of each one of these alleged causes" (Seligman)

In the countries of the modern world, the relief of poverty has taken the forms of private as well as public relief

The Right to Public Relief

There are three possible reasons why people do not work

(1) They may not have the strength to work This is the case with children, the aged and all who suffer from chronic disease or permanent infirmity (2) They may not have the means to work, they may not have the materials or implements required (3) They may not have the will to work (1) Now society has to make provision for the first class for reasons of social solidarity Civilised society considers it a duty to save helpless children and the aged from starvation (2) Society takes care of the second class for it is in a measure responsible for misfortune Modern economic progress causes unemployment and crises, and it is but just that society which benefits by this progress should make provision for those who suffer by unemployment and crises (3) The third class consists of drunkards, vagabonds and other criminal elements If uncared for, they would commit crimes and would have to be maintained in jails at the expense of society And the state would find it more economical and prudent to take care of these from the first and thus to reduce crimes instead of simply punishing them

Prof Gide argues on these grounds for the granting of public relief to persons who have not the strength to work, those who have not the means to work and those who have not the will to work

The dangers of poor relief

The classical economists and prominent among them Malthus have emphatically pointed out the dangers of poor relief They hold "the number of paupers tends to increase in direct ratio to the help they may count upon" And this danger is particularly to be feared when the aid is given by the state The reasons they give are the following

(1) The right to relief tends to develop improvidence among the population receiving relief (2) The right to relief causes a rapid increase of population among the pauper classes (3) Relief tends to impoverish the productive classes of the society for the benefit of the pauper classes

But as Prof Gide points out these arguments are useful and serviceable only so far as they make us recognise that poor relief should be carefully organised, otherwise it may produce serious evils It has been found by actual experience in England and in other countries that poor relief properly administered does not tend to develop improvidence, does not bring about a rapid increase in the pauper population and does not unduly burden the productive classes of the society And so for reasons of social solidarity the right to relief must be granted

The Right to Public Relief

All the different plans for improving the condition of the labouring classes(e g trade unions, profit sharing, gain sharing and welfare arrangements, labour laws etc) will yet leave untouched certain cases of misfortune, improvidence and social wreckage And it is the duty of the state to care for these cases by giving them relief from the public funds *Modern conceptions of social duty demand this from the state.*

In the granting of public relief, care should be taken that public charity does not run the risk of demoralising the character of the recipient of the charity

(1) The state can relieve the pauper, the insane, the blind, the crippled without any danger of degrading their character

(2) The same thing is true as regards the care of orphans and neglected children by the state Good care taken of them may make them better men and women and better citizens of the future

(3) Old age pensions under safe-guards can also be granted by the state without unduly undermining the thrift and the self-respect of the recipients

(4) The great difficulty is in connection with the able-bodied adults The general principle in this connection should be—*relief should be made effective but not unduly attractive If it is made unduly attractive then labourers* will leave independent work and *will depend more and more upon public charity and thus will be demoralised*

The English poor law investigators of 1832-34 decided that relief effective but not unduly attractive can be given by enforcing the workhouse test, administering poor relief to the able-bodied in the workhouses, where they are made to work under comparatively unattractive conditions, and by abolishing out-door relief (relief outside the workhouses)

(Modern experience shows that in certain cases and for persons in temporary difficulties, out door relief is however a more suitable remedy than indoor relief in the work house)

History of the English Poor Law

The history of the English poor law furnishes instructive lessons as to the true principles which should regulate poor relief by the state

First period (1601 1782)

The permanent pauper system of England was created by an Act passed in 1601 during the reign of Elizabeth This act gave every person in the kingdom a legal right to public relief if required, and it followed the correct principle of not making relief unduly attractive, it compelled the able-bodied poor to work, and the funds for granting relief were to be raised by taxation

Though the principle was strict, a period of somewhat lax administration brought about evils So by the middle of the seventeenth century and also towards its end, laws had to be passed by which the administration was made more strict and workhouses were constructed

On the whole however it can be maintained that the spirit underlying the administration of the poor law was strict and severe *Despite some unnecessary harshness, the effect on the working classes was wholesome for it was made undesirable to become a pauper*

Second period (1782 1834)

The wise severity of the first period was not properly appreciated a later stage, and there was *a reaction against the former strict-*

A number of Acts passed during the reign of George III indicated the new lenient spirit. Gilbert's Act passed in 1782 *abolished the workhouse test* and this Act also provided that the *poor law guardians were to find work for labourers* who could not find work and help was to be given them to supplement their wages when necessary.

The results of the leniency were disastrous. The large allowance for each child led to a great increase in the pauper population and the larger allowance for each illegitimate child degraded the morals of the people and almost abolished female chastity among the English labouring classes. Pauperism enormously increased.

Pauperism enormously increased because (1) under the poor law, the pauper was better provided than the honest, industrious labourer who tried to be self-supporting, and (2) there was a comparatively large allowance for each pauper child. *Immorality was encouraged*, the allowance for an illegitimate child being greater than that for a legitimate child. And the productive classes, the thrifty, honest and industrious were heavily taxed to support an increasing pauper population, indolent, thriftless and dissolute. The amount spent in the relief and maintenance of the poor rose to enormous, and even ruinous sums.

Third period (1834—

These serious evils made people realise the urgent necessity for poor law reform. And so the Poor Law Amendment Act of 1834 was passed. *This Act restored the strictness of the principle of the Elizabethan Act of 1601.* It re-established the salutary principle of making the position of the pauper undesirable, and thus stimulating him to achieve self-support; and with this object *it restored the work-house test*, making able-bodied labourers work in work-houses.

The Act abolished allowances in aid of wages, discouraged illegitimacy by punishing the father, and facilitated the migration of labourers by modifying the law of settlement.

The effects of the New Poor Law were marvellous, and the burden of pauperism was greatly reduced within a short time.

The Moral

According to Walker, the moral of this history of the English Poor Law is plain and simple. "*It should be the prime object of legislation to make the situation of the pauper less agreeable than*

that f the nte n lcn do a r, and th it o will interal" (Walker)

The humaner spirit of the 19th century and after led to discontent with the existing Poor Law, and a new Poor Law Commission was appointed in 1905.

The Poor Law Commission (1905 1909)

The Report of the Poor Law Commission of 1834, was quickly carried into effect in the law of the country Very different has been the fate of the Poor Law Commission appointed in 1905 and submitting Reports in 1909 There are two documents,—the Majority Report signed by eighteen members, and the Minority Report signed by four members and advocating socialistic views

The Majority Report summarises what it considers to be the main principles of a reformed poor law viz (1) that treatment of the poor should be adapted to the needs of the individual and there should be proper classification (2) that there should be fuller co-operation between the poor law authorities and local and private charities (3) that the system of public assistance should include processes of help which would be preventive, curative and restorative (4) that instincts of self-respect and self-maintenance should be fostered in every way

The principle of curative and restorative treatment of the individual is said to be a discovery of this Commission, in fact it is much older and it is all due to the growing humanitarianism and strengthening democratic spirit of the age The poor should not only be maintained, but every effort should be made to restore the sick and suffering poor as far as possible to the full stature of their manhood, physical, intellectual and moral

(The Old Age Pension Act of 1908 for the aged poor, the Labour Exchanges Act of 1909 for the unemployed and the Insurance Act have dealt with different aspects of this poverty problem in England and much valuable experience has been gained)

India and Poor Law

The Indian government practically accepts the duty of supporting the poor in the case of (a) European vagrants (b) lunatics (c) and children with criminal tendencies In India (unlike Britain) the government does not accept the duty of supporting the poor as

regards the general population (except in times of famine)——India has no Poor Law, and the relief of the poor is generally by private charity often indiscriminate, generally unorganised but full of that kindly human sympathy so characteristic of the Indian people

Co-operation

Co-operation in production, consumption, credit etc

Co-operation has been called the one successful social experiment of the nineteenth century In the different spheres of production, consumption, credit, co-operation is doing an immense amount of good to promote the true welfare of the workmen and its future is full of the brightest promise for the progress of the working classes

Co-operation has been tried, in retail trade, in credit and banking operations and in production And it has been most successful in retail trade, less in credit and banking and least in production

For different kinds of co-operation see Part I, page 212

I **Consumers' co-operation** or co-operative purchase of commodities

Co-operation in retail trade (sometimes called distributive co-operation) or the co-operative purchase of commodities is the simplest and most successful kind of co-operation Consumers of commodities combine to purchase what they need ~~They form a company~~, employ a manager and clerks, subscribe for shares, and this company purchases the commodities and then it sells them to its members In this way, the shopkeeper is eliminated, the *consumers become in effect their own shopkeepers*

These associations of consumers for co-operative purchase are also called co operative stores In this kind of co operation England has taken the lead

Advantages

The advantages are very considerable (1) The shopkeeper being eliminated, his *profit goes to the consumers* (The consumers' association gets goods at wholesale prices and sells at retail market prices and thus it makes a profit, this profit goes to the consumers

partly as interest on their capital and partly in proportion to their purchases)

The profit is paid at stated intervals and this accumulation of profit for some time makes it considerable and increases its chance of being saved The co operative stores thus make savings and also *act as savings banks*

(3) The consumers are their own shopkeepers and so the association *does not lose money through bad debts*

(4) The consumers naturally take care that their own shop supplies *goods* to them *of the proper quality* and not adulterated and injurious articles Also *less expense has to be incurred for advertising* (Prof Taussig points out that the co operative stores in the United States take conspicuous premises on the main streets and have the outward appearance of the ordinary retail shop and so they do not save much in these respects)

Some part of the profit is spent for educational and other welfare purposes

In England and Scotland, distributive co-operation or consumers' co-operation has met with very great success On the continent of Europe also there has been a considerable development of distributive co-operation In the United States, the conditions are different and so distributive co-operation has not attained the same sort of growth and importance in that country

II Co-operative Credit Societies

In co-operation for securing better credit facilities, the Germans have taken the lead, and the names of Schulze Delitzsch and Raiffeisen will be ever memorable in this connection

The essence of co-operative credit consists in co-operation as regards credit i e co operation in borrowing and lending Each farmer borrowing on his own individual security will have to pay a high rate of interest and will not in many cases be able to get a lender having sufficient confidence in him to lend him money, in co-operative credit, the farmers borrow on their joint security which is stronger than individual security, and therefore they are able to borrow at a low rate of interest The capital that is borrowed on the joint security of members is then lent to the members at slightly higher rate of interest, and in this way the members are enabled by the system of co operative credit to get loans at a rate

lower than they would get if they borrowed each one of them separately on his own individual credit This is the essence of co-operative credit

(a) Co operative credit societies lend generally to members only (b) and they generally lend on the personal security of the borrowers, not on mortgages or on the security of working capital etc (c) and the management is in the hands of the members

Co operative credit societies are of many kinds, They may be, divided into two principal classes, (a) rural co-operative credit societies chiefly for agriculturists (b) urban co operative credit societies for the small artisans in towns etc

(A) *Co-operative Credit Societies for agriculture The Raiffeisen type* The agriculturist requires capital for current working expenses and he has to borrow capital for this purpose, the period of the loan being longer than that for commercial loans represented by bills of exchange but shorter than that of mortgage loans

One of the most successful types of co-operative credit societies was founded by Raiffeisen in Germany who started his first agricultural bank in the year 1849

These co-operative credit societies for agriculture have generally the following features (1) The members bring *no share capital* and (2) they receive *no dividends* (all profits go to constitute an indivisible fund, which by continually increasing enables the society to reduce its rate of interest on its loans and to make itself less dependent on outside capital) (3) The members have unlimited liability, *they are jointly responsible to the extent of all their goods* (4) *All offices are unpaid except* sometimes that of the cashier or accountant (5) A member knows intimately the other members and so he can accept unlimited responsibility for them The principle of unlimited responsibility makes each member scrutinise strictly whether the money borrowed by other members is being properly utilised or is being wasted *This prevents the unproductive use of loans* by members and is of the greatest possible importance in securing the solvency and development of the co-operative society

The principal advantages of these co-operative credit societies are—

(a) The members get loans for their agricultural operations at a reasonable rate of interest and so they free themselves from the clutches of the grasping money-lenders

(b) The unproductive use of loans is checked This will not be done at least to the same extent by a government bank or other credit institutions

(c) These societies establish a connection between credit and saving, and they encourage thrift and help the accumulation of capital by the members

(d) The agriculturists freed from the grip of the money-lenders and getting loans on easy terms for their agricultural operations prosper greatly from the economic stand point and they also develop self-respect, thrifty habits, temperance self reliance, self-help and the capacity for organization for improving their condition

These co operative societies have been immensely successful in Germany, in Italy and they have a great future before them in India

(B) *Urban co-operative credit societies*

Credit co-operation rural as well as urban first arose in Germany We have seen that the most successful type of association for co-operative credit in agriculture was founded by Raiffeisen, a German, and one of the most important types of urban co operative credit societies was founded by another German Schulze Delitzsch and it is named after him

The Schulze-Delitzsch type of society The characteristic features of these Schulze Delitzsch societies are (1) The unlimited liability of the members, which is the essential feature (2) Societies aim at developing credit, but they also aim at developing thrift and habits of saving among the members (3) Unlike Raiffeisen societies, they have share capital (4) and members get dividends on their shares (5) And to give high dividends, comparatively high rates of interest are charged to the borrowers

It will be seen that in Raiffeisen societies profits are not paid and expenses are kept down at a minimum, so that all funds may be made available for lowering the rate of interest to the borrowers. In societies of the Schulze Delitzsch type, so much attention is not paid to keeping down the rate of interest

The organisers of these societies in Germany hope to give small industries the means of effectively fighting large industries, by providing small scale industry with the capital and equipment which it lacks

In Italy co-operative credit societies founded by M Luzzatti are flourishing greatly, but in France and in England they have not attained a very considerable measure of success

Advantages

The advantages from the urban co-operative credit societies are similar in character to the advantages from rural co-operative credit societies

(a) They help members to get loans at reasonable rates for their work

(b) They check unproductive use of loans

(c) They encourage thrift and saving

(d) They help to bring about not only the economic but also the moral and social advancement of the members In these urban societies, however, there is less of the true co-operative spirit, the payment of dividends on shares introduces an element of capitalism into the organization

Some interesting kinds of Co operation

Other sorts of Co operative societies have prospered greatly in Germany—societies for the purchase of materials, for the sale of products, for the purchase and use of machinery too expensive for any one member etc

In Denmark and some continental countries co-operative effort among agricultural producers has been strikingly successful in curing bacon and in the packing and shipping of eggs etc

III Co-operative production

Co-operation has been least successful in this sphere, and co-operation can modify radically the present social and industrial organization only by achieving success in this line

The advantages of co-operative production, and the dangers and the difficulties which up to the present time have prevented co-operative production from attaining any wide-spread success—these are given in Part I pages 212-213

As Prof Taussig points out "the essential difficulty in the way of Co-operation in production is that it attempts to supersede the business man where he is most needed *Co-operation cannot dispense with these leaders, it would have to enlist them*"

Thus as regards the future of the Co-operative movement there is a great and supremely useful future for Co-operation. But the hopes of economic reformers of a generation ago that the Co-operative movement will revolutionise the social order—these hopes, in the opinion of many modern economists, are not likely to be fulfilled.

And the reformers are now looking to other remedies, labour organizations, labour legislation and the extension of public management and control.

Summary

The disabilities of [illegible] the labourer [illegible] various disadvantages [illegible] immobility and weak bargaining [illegible] are reduced by Trade Unions.

Trade Unions have (a) militant, (b) [illegible] functions. The Trade Union by its organized action helps to raise wages up to the marginal productivity of labour and under certain conditions can raise wages greatly in a particular trade by artificially restricting the supply of labour.

The *old unions* generally paid more attention to providing benefits of different kinds; the *new unions* are less concerned with benefits; they are more for strikes and participation in politics. (A very recent development in England is the movement for *direct action* by strike to enforce the working classes their political and economic demand, a section of the workers having lost faith in political agitation and parliamentary action.)

The *strike* is a method of industrial war. It is a destructive weapon and causes loss to employers, to capitalists, to labourers through loss of employment and wages, to consumers, and if too frequent may inflict permanent injury upon the industries of a country.

Advantages. Defenders of strikes maintain that strikes strengthen the solidarity of the trade union movement, increase the confidence of the workmen in themselves, teach masters to respect their men and thus help labour to raise wages and get better conditions of employment.

In most industries the strike is an evil but a necessary evil, and has to be tolerated; but in certain vital industries it must be prohibited in the public interest. There is no necessary connection between the trade union and the strike.

The usual arguments against *factory laws* are (i) that they interfere with liberty, (ii) that they are unnecessary and the labourers are able to take care of themselves, (iii) they diminish output, injure business and bring down wages. The principal arguments for factory laws are (i) moral considerations, (ii) economic considerations, viz. (a) factory laws, on the whole, help to increase output, (b) and they safeguard the industrial future of the race, (iii) considerations of national strength and social welfare.

Industrial war brings about serious evils in its train, and so we require the agencies of industrial peace. The principal *agencies of industrial peace* are profit-sharing, welfare arrangements, sliding-scale, arbitration (compulsory and voluntary).

Profit-sharing (i) promotes the zeal and efficiency of employees (ii) makes them careful and economical in the use of materials and machinery (iii) and thus increases the total product (iv) and increases the income of the employees who receive wages at the current rates plus a share of the profits. Profit-sharing has its difficulties, and it is disliked by labour leaders and also by some employers who regard the power of dismissal a more effective instrument than profit-sharing.

Arbitration is (i) voluntary or compulsory (ii) public or private. Private boards of arbitration are based on voluntary trade agreements and collective bargaining. Public boards of arbitration are often boards of conciliation as well as boards of arbitration.

Compulsory arbitration has its difficulties and it should be introduced only in fundamental industries (like railways and other industries upon the steady activity of which the whole community is dependent) and also in sweated industries.

Unemployment. Causes (I) internal viz (physical, mental and moral defects of labourers) (II) external (i) cyclical movements (ii) seasonal demand (iii) seasonal supply (iv) changes in industrial methods etc. (v) casual labour (vi) inelasticity of wage-rates.

Remedies (a) the labour exchange (b) spreading the diminished demand for labour over all labourers in the affected trades (c) making the public demand for labour compensatory as far as possible.

Poverty and the poor law. The causes of poverty are complex as civilisation itself. The right to public relief is based upon modern conceptions of social duty, and the state must take particular care that state charity does not demoralise the recipients of the charity. The greatest difficulty is in connection with the able-bodied poor and for them relief should not be made too attractive, their position should not be made more desirable than that of the independent labourer.

Co-operation is the most successful social experiment of the 19th century. (a) *Consumptive co-operation* (also called distributive co-operation). *Advantages* (i) It eliminates the shopkeeper's profit and secures it for the consumer (ii) prevents adulteration of goods (iii) avoids bad debts (iv) saves much in connection with advertising etc.

(b) *Co-operative credit* had its origin in Germany. Its remarkable progress is one of the hopeful signs of the future. Some important features are (i) loans to members only (ii) personal security for the loans (iii) management by members.

(c) *Co-operative production* has not been so successful as co-operative consumption.

Its advantages (i) The labourers are their own employers and in addition to wages, get profits (ii) much labour of superintendence is saved, and the energy and industry of workmen are stimulated (iii) strikes are prevented (iv) more continuous employment for labour.

Questions

1 (a) What are Trade Unions? Give their functions and indicate the methods which they adopt to raise wages (1910 H)

How far is it possible for Trade Unions to raise wages (1910 H)

(b) Trace the origin of Trade Unions. Explain the nature of any change which may be noticeable in the aims and objects of Trade Unions in recent years (1910)

(c) Is there any necessary connection between unions and strikes (C U 1910)

2 When can wages be raised in a trade by an artificial restriction of labour supply (1912 H)

Or

Carefully consider whether labour can raise the level of normal real wages by means of combination (C U 1913)

3 (a) What is a strike? What advantages do labour leaders claim for strikes

(b) Examine the economic influence of strikes with special reference to their effect on wages (C U 1912)

4 State the arguments for and against factory legislation (C U 1911)

5 What are the principal agencies for industrial peace? Estimate the value and importance of each of these agencies

Consider some of the more important plans to secure settlement of differences between capital and labour (C U 1911)

Or.

Point out the advantages and the difficulties relating to profit sharing

6 Discuss the more important causes of unemployment in the modern industrial world, and examine the efficacy of the remedies usually suggested for it (1911 H)

6 (a) What are the duties of the state in relation to the poor?

(b) Trace the development of the present system of poor law administration in England. What were the principles established by the Elizabethan Act of 1601, and how far have these been adhered to or departed from in modern times? (C U 1909)

8 Give a short account of different varieties of co-operation viz (a) co-operative production (b) co-operative consumption (c) co-operative credit, noticing advantages and difficulties relating to each

CHAPTER V

Interest

Definition of interest

The payment that is made by the borrower to the lender for the use of capital is called interest

Opinions about Interest in the past and in the present

Now the question as to whether interest should be paid is one which has engaged the attention of mankind from earliest antiquity The law of Moses among the Jews condemned interest, and the lending of money at interest was also attacked by Aristotle, Plato, two of the greatest names among the Greeks, Cato among the Romans and the Christian Church of the middle ages

The opposition of early and medieval peoples to the payment of interest is easily explained Money was borrowed in this period chiefly for the purpose of consumption, the borrowers were poor and in difficulties, and unable to pay the interest and repay the capital they were often reduced to slavery or to a condition of absolute and hopeless misery

The position has completely altered now Now borrowers generally borrow for the purpose of production, they get an income from the capital borrowed by them, and so the borrowers can without difficulty pay something as interest to the creditor for the use of the capital Modern opinion therefore does not condemn interest Even in modern times however many countries have usury laws prohibiting excessive rates of interest on loans

Theories of Interest

Different explanations of interest have been given Some of these theories, are briefly described and examined below

(1) **Productivity theories** (Malthus, Say, Carey & others)

According to these theories, interest is a price paid for the *productive services* of capital The capital that is borrowed helps to produce wealth and so the borrower pays interest

Objections,

(a) Productivity theories will not apply to capital borrowed for the purpose of consumption they will apply only to capital borrowed for production

(b) Production with capital produces more goods than production without capital—*capital produces more goods but not necessarily more value always*

Again it has been said that it is not proper to say that capital produces value, rather it is capital that helps to produce other goods and it is the value of these goods that determines the capital value It is not capital invested in an orchard that gives value if the orchard does not produce anything it may not have any value It is the goods (fruits) produced by capital that have value and the annual production of these fruits will determine the capital value of the orchard

(2) **The use theories** (J B Say, Schaffle, Knies, Menger and others)

It is maintained by some writers that the borrower pays interest for the use of the capital as the tenant of a house pays rent for the use of the house

Objections

This explanation of interest does not apply to interest on circulating capital, circulating capital is destroyed by a single-use Why should interest continue to be paid when the capital has been destroyed and is no longer in use?

(3) **Abstinence theories** (Senior, Cairnes etc)

According to these theories, interest is the payment made for *abstaining* from unproductive use of wealth

Objections

This theory takes into account only the supply side of interest, it maintains that the supply of capital depends upon the abstinence exercised by the savers of capital The abstinence theory neglects the demand side of interest, and on the supply side the explanation is not complete (See Part I page 145)

(4) Labour theories

Interest is paid for the capitalist's *labour* In some labour theories, capitalist's labour means the labour of producing capital (*b*) and in some other labour theories it refers to the labour of saving wealth

(5) Exploitation theories (Marx and Rodbertus)

Interest arises from *exploitation*, from robbing the labourer of part of the total wealth which he produces The whole value of the product is due to labour, but the labourer gets only a part of the value as wages, and part of the value produced by the labourer goes to the capitalist as interest, the capitalist thus depriving the labourer of a portion of the wealth produced by him The leading advocates of the exploitation theory are Karl Marx and Rodbertus This theory is based upon the fundamental mistake of regarding the whole value of the product as due to labour, and so it has been rejected by economists

(6) The Austrian theory of interest[1]

The Austrian theory of interest largely associated with the name of Prof Bohm Bawerk, one of the leaders of the Austrian School, is briefly this

(1) *The element of time is the cause of all phenomena connected with interest*

Future goods are always less valuable than present goods Future goods are less valuable than present goods when the future goods are uncertain, and future goods are less valuable than present goods of the same amount even when both are equally certain—and this is because desire which is the source of value is stronger for things near in point of time than for goods far away though equally certain

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[1] "*The essence of interest in short is discount* The capital replaced plus interest is the full equivalent of the capital loaned

The loan is a real exchange of present goods against future goods For reasons I shall give in detail in my second volume present goods invariably possess a greater value than future goods of the same number and kind and therefore a definite sum of present goods can as a rule only be purchased by a larger sum of future goods Present goods possess an agio in future goods This agio is interest" Bohm Bawerk—Capital and Interest

(Bk III, Ch IX)

T[illegible] [illegible] [illegible] because the present goods given [illegible] us at present [illegible] more valuable than the same amount of goods [illegible] expected [illegible] in future.

(2) [illegible] the Austrian economists point out the "*technical superiority*" [illegible] of capital in the work of production—this technical superiority of future goods stimulates the demand for capital.

Demand and supply theory of interest.

The rate of interest depends upon the equilibrium of demand for and supply of capital. *The demand for capital* depends upon its productiveness; it depends upon the marginal productivity of capital. Capital will be used by each producer so long it gives him a nett yield.

Each producer has his own demand for capital and the total demand of all producers gives the total productive demand for capital in the community. We must add to this productive demand the demand for consumption. The aggregate of the productive and consumptive demands for capital gives us the total demand for capital in a community.

Then we come to the *supply of capital*. The supply of capital depends upon (*a*) the customs and traditions of the people with regard to saving, (*b*) their habit of realising the future, (*c*) the strength of family affection among them, (*d*) security of life and property, (*e*) the presence or absence of opportunities for investment of capital, (*f*) rate of interest.

Some persons would save a certain amount of capital if the rate of interest was *zero*, and indeed even if it was a *negative rate*. Capital would be saved even under these circumstances for the sake of providing for a man's family and for his own self in the future. The capital that would be saved however with a zero rate or a negative rate of interest would be a small amount, insufficient for all the needs of the society.

To induce men to accumulate the large amount of capital required by society, a rate of interest has to be offered.

The rate of interest is determined by the demand for, and the supply of capital. "Interest, being the price paid for the use of

4½ 25 27

capital in any market, tends towards such a level that the aggregate demand for capital in that market at that rate of interest, is equal to the aggregate stock forthcoming there at that rate "

In this case 4% will be equilibrium rate bringing in equilibrium of demand & supply & it will be the market rate of Int

Rent and interest

(1) Rent is the income from land and other natural resources, interest is the income from capital They are thus both incomes from material aids to production Here is an important resemblance (2) And there are great differences between land and capital Land is not made by man but is a free gift of nature capital is produced by man The amount of land in a country is limited by nature, its supply is inelastic , in the long period the amount of capital is not so limited, its supply can be increased and is increased by the efforts of man

(3) Again in the short period, there are some resemblances between rent and interest The supply of land has no elasticity in the short period as well as in the long period , the supply of capital has also comparatively little elasticity in the short period

In the long period, this point of resemblance disappears This is because in the long period, the supply of land remains inelastic while the supply of capital becomes elastic

(4) It is also pointed out that historically rent increases while the rate of interest tends to fall

(Prof Marshall has said *scientifically speaking rent, quasi-rent and interest are three species of the same genus* He implies that the resemblance between interest in the short period and rent entitles us to regard them, broadly speaking, as belonging to one group of phenomena)

Nett and gross interest

Nett interest means the earnings of capital when there is no risk of losing the capital and no trouble of management

Nett interest is also called *pure interest* or *economic interest* The interest paid by a perfectly solvent government upon money borrowed by it approaches most closely to this pure interest or nett interest

What we commonly speak of interest is generally gross interest Gross interest includes—

(1) Pure interest, (2) insurance against risk and (3) also earnings of management (4) Remuneration for inconvenience

The greater the risk, the higher will be the gross interest—the risk involved may be the *trade risk* of the particular business for which capital is borrowed or it may be *personal risk* relating to the borrower's personal character or ability Again of two loans of equal amount that which requires a greater degree of supervision and management must pay a higher rate of interest to the creditor for his greater trouble of management

Rate of interest

It has been already explained as to how the rate of interest is determined by the demand for and supply of capital

(A) *Different rates of interest in the same market*

We find that there are different rates of interest (gross interest) in the same market To what causes are we to ascribe these different rates of interest in the same market? The answer is simple Different rates are due to (1) *difference in the risks and* to differences in the *trouble* of management required (2) Again even when the risk and the trouble are the same, there may be *differences in the rates* of interest charged in different parts of the same market *on account of comparative lack of mobility of capital*

(B) *Different rates in different markets*

Different rates of Interest in different countries

(a) *All that has been said of differing rates of interest in the same market holds good also of differing rates of interest in different markets* And there are other additional causes

(b) *One important cause is the disinclination of capital to migrate to a foreign country*, The people of a country will accept a lower rate of interest on capital invested within the country than for capital to be invested in a foreign country And this disclination of the people to lend abroad is due (i) partly to the suspicion that foreigners and foreign courts may not be fair to them and their capital (ii) partly to the danger of war suspending the payment of interest or principal by the foreign country and (iii) also to some extent to the fact that foreign investments must be made generally

through an agent whose judgment or whose honesty may not always be all that is desired

History of the rate of interest

The fall in the rate of interest from 5 p c to 3 p c is one of the striking economic phenomena of the second half of the nineteenth century

Since 1900 there has been a marked rise in the rate of interest and it will be considerably raised by (a) the destruction of vast amounts of capital in the war (b) the immense demand for capital throughout the world for the purposes of reconstruction after the war

So much for the immediate future

Then as regards the remote future

Zero rate and negative rate of interest

Some economists have made forecasts about the movement of the rate of interest in the remote future and they argue that the rate may fall to zero or it may fall below that and the rate of interest may become a negative one This, they expect will happen with a great increase in the supply of capital while the demand for capital will not increase at the same rate because opportunities for its employment are limited in manufactures and transport aud agriculture will become less productive in future on account of diminishing returns These writers exaggerate the amount of fall in the rate of interest to be expected in future The accumulation of capital is proceeding at a great rate The demand for capital though it may not increase as fast as the supply will continue to increase. New fields of industry will be opened up and for them capital will be wanted

And there must be a rate of interest for inducing men to accumulate a sufficient quantity of capital If there is no interest, many men would not save much and so the supply of capital will be insufficient to meet the demand Thus we expect the rate of interest will fall in the remote future when there is a large accumulation of capital and comparative diminution in the demand for capital But there will be a rate of interest to make the supply equal to the demand

And it is to be observed that Prof Foxwell's view that there is no absolute minimum is more probable than that of Mill

Rate of Interest and the volume of currency

We shall consider this question (1) as regards the rate of interest charged by banks for short period bank loans (2) as regards the rate of interest in general

(1) If money is plentiful in the money market, then the rate of interest charged by banks will be low , and if money is scarce, the rate of interest will be high

An increase in the volume of *metallic* currency will increase the metallic reserves of banks , and when the reserve increases, a bank

lends more freely to business men and at a low rate of interest. A reduction in the volume of metallic currency in a country brings about a rise in the rate of interest charged by banks on short period bank loans. So much for the bank rate of interest in the short period.

(2) Then we come to the general rate of interest, and the long period. Other things being equal, (*a*) an increase in the volume of currency will bring about a fall in the value of money (and a rise in general prices) and (*b*) a decrease in the volume of currency will bring about a rise in the value of money (and a fall in general prices.)

And it has been pretty conclusively shown by Prof. Irving Fisher that the *rate of interest tends in the long run to accomodate itself more or less closely to the changed value of money and* therefore *to counteract in part at least the loss caused by changes in the value of the principal of the debt.*

The rate of interest must change falling as money appreciates (through a diminution in the volume of currency) *and rising as money depreciates* (through an increase in the volume of currency.)

Regulation of Int. Is Government interference justifiable.

Summary

1. Interest is the remuneration paid for the use of capital.

2. The rate of interest is determined by the relation between the demand for and the supply of capital, and the equilibrium rate is such that it equalises the supply and the demand.

3. *Gross interest* includes (1) *pure or net interest* (2) insurance against risk (3) earnings of management.

4. The rate of interest tends to fall as the supply of capital increases faster than the demand for it. The war has destroyed large amounts of capital and has brought about a great rise in the rate of interest.

Different rates of gross interest in the same market are due to differences in risk in trouble of management, and also to some lack of mobility as between different parts of the same market. One important cause (in addition to other causes) of different rates in different countries is the comparative disinclination of capital to migrate to a foreign country.

Questions

1. What is interest? Why was the taking of interest condemned in early times, and why is it not condemned now?

2 Explain and examine briefly (a) the use theory of interest (b) the abstinence theory (c) the exploitation theory (d) the Austrian theory of interest

3 Give a brief sketch of the complete theory of interest

4 (a) Distinguish between net interest and gross interest

(b) Why are there different rates of interest in different countries? And why are there different rates in the same market

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CHAPTER VI

PROFITS

What is Profit?

Profit is the income of the entrepreneur.

The difference between the total money income which an entrepreneur receives and his expenses of production constitutes the profit of the entrepreneur *Profit thus is a surplus above the expenses of production.*

The component elements of profits

The total profit or gross profit constitutes a composite income, including the following elements

(1) *The entrepreneur's wages of superintendence* The entrepreneur often does a certain amount of work, relating to his business, which can be done by salaried managers, and the remuneration which he receives for this is his wages of superintendence

(2) The *interest on the entrepreneur's own capital*, invested by him in the business The entrepreneur may borrow some capital for his work and he may invest some of his own capital and the interest which he receives on his own capital is another element of his total profit

(3) *Rent of land owned by the entrepreneur* is another element

(4) The entrepreneur is a risk taker *The function of risk-taking he must assume himself* and it cannot be transferred by him to

an employee, working for a salary *And the income of the entrepreneur which comes to him as a risk-taker constitutes the peculiar income of the business man*, an income which is never earned by any one except a business man who undertakes risks

Risk taking in this sense requires knowledge and foresight on his part and it involves careful estimates of the amounts of product that can be got from different combinations of labour, capital and land, careful estimates of market conditions and special skill in knowing when to buy and when to sell

The functions of the entrepreneur as a risk taker can be distinguished from his functions as manager The manager's function is to look after the *technical side* of production and to organize the factors of production the employer's function as a risk taker is to look after the *value side* of production, to make his use of capital, labour and land most remunerative by knowing when to buy and when to sell and at what prices Another element of the employer's profit consists in his *gains of bargaining* The entrepreneur increases profit by outbargaining the other agents of production and paying them less than their marginal productivity, by outbargaining the inventors of new machinery and processes, the consumers etc

These two elements of profits *viz*, (*a*) the income from risk taking and (*b*) the gains from bargaining may be regarded as constituting the *pure profit* of the employer

Pure profit is a purely personal gain due to the superior efficiency of management of the employer as compared with the marginal employer, and it is independent of any monopoly advantage, favourable conjuncture, or the mere labour of the manager as a superintendent

(5) Other elements of profit not depending upon the efficiency of the entrepreneur are the following

(*a*) *Monopoly gains* due to a monopoly advantage possessed by an entrepreneur

(*b*) *Conjunctural gains* resulting from a favourable conjuncture of circumstances which could not have been foreseen The farmers of America may make large conjunctural gains of this character in one year through the failure of crops in Europe The unexpected death of a king by creating unusual demand for mourning goods in the country will give large conjunctural gains to merchants who have

already got large stocks of these goods and will be able to sell them at a high price

So gross profits include many elements and one of these elements consists of pure or net profits, and the theory of net profits may be thus outlined

The price of goods in a community must be as to give to the most inefficient entrepreneurs (whose supply is required by the society), a profit including other items of gross profit (excepting pure or net profit)—otherwise the required supply will not be produced *The marginal entrepreneur gets no pure or net profits The entrepreneur more efficient than the marginal entrepreneur* gets a differential profit, the amount of the differential depending upon the extent to which the superior entrepreneur exceeds in efficiency the marginal entrepreneur

+ A zero rate of profit

Some American economists have held the view that the normal rate of profits is a zero rate

English economists are generally of opinion that there must be a positive rate of profits, and that normal profit is a part of normal supply price of commodities For Marshall's view refer to page 247

Different theories about profit

The word profit has been used in different senses and there are different theories of profits

(1) *The theory of the early English economists* English writers up to the middle of the nineteenth century do not separate interest on capital from the pure profit of the entrepreneur These writers use the word profit to refer to the total gain of an individual capitalist, employing his own capital and also doing the work of management himself *Profit* in this sense *includes (a) interest on the capital of the capitalist employer* and also (*b*) *his earnings of management*

(2) Walker's theory of profit

The fact that early English economists did not separate interest on the capital of the business man from his earnings of manage-

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+ "In a way this gain is self annihilating The uniform rate towards which pure profit tends, though it never reaches it in all groups at once,——is a zero rate Competition tends to annihilate pure profit"—J B Clark

ment was due to this—at this period business men worked generally with their own capital and not with much borrowed capital, and so the term profit was applied to the entire gain of the capitalist-employer due to his capital and also his management

In America however employers working with borrowed capital have long become a dominant feature of the industrial organization And *Walker restricts profit* to mean only the *net gain of the employer, employing no capital of his own* (Walker's profit does not thus include interest on capital)

Walker further maintains that *profits constitute a species of the same genus as rent*

(1) As rent on superior land is paid on account of its superior fertility or superior convenience of situation, so profit is due to difference in the business abilities of employers

(2) As there is no-rent land on which no rent is paid (the produce of the land being only just sufficient to pay the expenses of cultivation and contributing nothing to rent), so there is a no-profits class of employers The no-profits class of employers earn practically no profits, and they manage to subsist with great difficulty

(3) As the rent on superior land is calculated from the no-rent land, so the profits of the superior employers are calculated by comparison with the no-profits class of employers

(4) As rent is not an element of the supply price of agricultural produce, so *profits also do not form a part of the price of manufactured products.*

Criticism of Walker's theory

The following objections have been advanced against Walker's theory and his conclusions

(1) The supply of land is inelastic, it has got no supply price and this gives a peculiarity to rent, the income from land Profit is the income of capital and business power and business ability in command of capital has a supply price, its supply is elastic

(2) *A class of employers earning no profits also cannot permanently exist*

(3) Business men are attracted towards undertakings by the profits which they will be able to realise All prospective gains of

the business man enter into the profits which draw him towards the undertaking, all the investment of his capital and energies in making the appliances for future production and in building up the immaterial capital of a business connection, have to show themselves to him as likely to be profitable, before he will enter on them

Normal profit is thus an element of normal supply price, and forms part of the price of the manufactured product

(3) Marshall's view

By profits, Marshall refers to profits of capital and business power Maintaining the continuity of the English orthodox view about profits, he uses the word to include (a) interest on the capital owned by the business man and invested by him in his business and (b) also his earnings of undertaking and management

Profits in this sense constitute the reward of the capitalist for his risk-taking as regards his capital and also for his organizing The organizing ability of the employer has a supply price

Profits are thus justified from the stand point of private property under present conditions

(4) The socialistic theory of profits

For the socialistic theory which regards all profits as "legalized robbery" and for a criticism of that theory—see chapter on socialism

Profits per annum, and profits on the turn-over

In profits per annum we look at the annual rate of profits on the capital invested in a business, and the rate of profits on the turnover refers to the rate of profits that is made every time the capital of the business is turned over

Does the rate of profits tend to equality ?

There is *no general tendency of profits on the turnover to equality in all industries* In some industries the rate on the turnover is large, in other industries the rate on the turnover is moderate and in some others the rate on the turnover is low

The rate of *profits per annum also varies from industry to industry* Profits per annum are generally high in trades in which the work of management is difficult and risky, where capital is

relatively small and the wages bill is relatively large The rate of profits tends to be low in trades, in which there is a disproportionately large amount of durable plant, that requires but little trouble and attention when once it has been laid down In trades in which the speculative element is not very important so that the work of management consists chiefly of superintendence, the earnings of management will follow very closely the amount of work done in the business and a rough measure of this is found in the wages bill

The rate of profits on the turnover varies much more widely than the annual rate of profits on capital

(1) Through there is no general tendency of profits on the turnover to equality, there is *in each trade* and in every branch of each trade a more or less definite rate of profits on the turnover which is regarded as a fair or normal rate

(2) In the words of Marshall, *the least inaccurate of all the broad statements that can be made with regard to a general tendency of profits to equality in different trades is* that where equal capitals are employed, profits tend to be a certain percentage per annum on the total capital, together with a certain percentage on the wages bill It is in this sense that profits may be said to tend to some rough sort of equality

I Relation of wages to profits

(1) The relation of wages to profits is to be studied under two aspects In the long run wages and profits are complementary in the sense that business prosperity may mean both high profits and high wages It is chiefly through the existence of high profits that mankind under present conditions, has any assurance of that augmented output which is the chief factor in raising the marginal contribution of labour

(2) On the other hand, the immediate division of the product in each individual case and at any given moment antagonises wages and profits The more that is taken as profits by any single employer or group of employers, the less will be left for wages

II Wages and profits compared

(A) Business profits resemble wages in certain points, and

so Taussig says that profits are best regarded as simply a form of wages

(B) Yet the differences between business profits and wages in certain points are very great

(a) *The salient characteristic of the business man's work differentiating it from the work of the ordinary workman is that the business man stands at the helm of industry* and guides its operations Into his hands first flow the proceeds of the business, and it is he who distributes to the other agents of production their shares He gets as his profit what is left after paying the other agents of production—the income of the business man, his profit, has been therefore described as a residual share

(b) *The irregularity of the business man's income (his profits) offers a striking contrast to the much greater regularity of the rate of wages* (1) *The same enterpriser* may have a very large profit this year and next year he may have no profits at all , but the wages of the same workman will not fluctuate so greatly from year to year (2) Again the wages of labourers of the *same grade* do not vary by any considerable amount while the variations in the profits of business men of the same grade are much more considerable due to the chance elements in profits

(c) *The differences in the profits of different entrepreneurs belonging to different grades are very great* , and such great differences are not to be found in the wages of labourers of different grades And to what facts are these great differences of profits due? It is due in some measure to chance but largely it is due to the possession by some individuals of qualities not possessed by others

(d) There is thus a larger element of quasi-rent of ability in profits than in wages

(e) *With the fluctuations of prices, profits fluctuate and the fluctuation in the rate of profit is greater than the fluctuation in price* The fluctuations of the business man's profits precede fluctuations in wages and are more extensive *A small rise in price will often increase very greatly the profit of the business man and will lead to a rise in wages which is much less extensive* And as the rise in wages is not generally in proportion to the rise in prices, the real income of wage earners will diminish and they will suffer while the business men will be enjoying prosperous times

Interest and profits

Early English economists did not distinguish between interest and profit. At this stage the employer was also a capitalist and the total income of the employer-capitalist was regarded as his profit, and this total income included interest on the capital invested and also the remuneration for business management or organization.

American economists have, however, brought about a distinction between interest and profit which is now widely accepted. Interest is the remuneration of capital, and profit is the remuneration of the business man for his services of business management and risk taking.

Summary

Questions

1 What do you understand by gross profits Distinguish between gross and net profits What are net profits? How are net profits to be calculated?

2 Sketch briefly the theory of net profits In what respects does the theory of net profits resemble the theory [illegible]

3 Discuss the following statements of Walker

(i) Profits are a species of the same genus as rent

(ii) Profits do not form part of the price of manufactured products (1909)

4 In what sense do profits tend to an equality?

5 Distinguish between (a) profit and interest (b) profit and wages (190[illegible], II)

BOOK VI.

The State and Economic Life.

CHAPTER I

Public finance

Public finance is that branch of economics which deals with the revenues and expenditures of governments and with the administration of such revenues and expenditures

Carl Plehn defines public finance as "the science which deals with the activity of the statesman in obtaining and applying the material means necessary for fulfilling the proper functions of the state" The expenditures of the state are for performing the state functions, and to meet these expenditures the state has to raise revenues and to administer them

Importance of public finance in modern times

(1) The total amount of public expenditures at the present time is of enormous dimensions and an enormous aggregate of public revenues has to be raised every year to defray, these expenditures

(2) Not only the total of public expenditures is very large, it is increasing and it is increasing at a very rapid rate The gradual expansion of public expenditures is being brought about by the

expansion in the functions of modern governments. A modern government performs many duties in connection with the poor and unfortunate, in connection with sanitation, education and public works etc., which were not undertaken by governments of earlier periods.

Government business is the largest single business in every advanced modern state. The total expenditures and revenues of a government every year are much larger than the revenues and expenditures of the richest multi-millionaire within the state. The government is the largest employer of labour within the country and so influences greatly rate of wages and conditions of employment for labour. And government business is not only vast in its extent, the influence (direct and indirect) that the Government revenues and expenditures exercise upon the production, distribution and consumption of wealth is enormous.

The war has enormously increased national expenditures and has multiplied many times national debts—the English national debt during the war has increased from about 600 million to about 8,000 million, more than ten times, and similar increases have taken place in other countries. Even after the war, national expenditures on account of interest charges on national debt, war pensions etc. would be much larger than in the pre-war period—Marshall's † estimate for after-war expenditure in England is that it will be more than twice as much before the war, and possibly much more.

For all these reasons a study of the activity of the state, its revenues and expenditures is of great importance.

The law of increasing public expenditures

The immense increase in public expenditure within recent times has led to the formulation of the law of increasing public expenditures by Prof. Adolf Wagner, one of the leading economists of modern Germany, and the law is thus translated by Prof. Ely:

"Comparison between different countries and different periods shows regularly among progressive nations an extension of public activities. This manifests itself extensively and intensively: the state and its subordinated political units continually undertake new functions, and they perform their duties, old and new, better and better.

† After-war Problems.

In this way, that is through public agency, the needs of the population to an increasing extent specially their common needs are satisfied and the public services for satisfaction of needs continually improve in quality The clear proof of this is given statistically in the increased demands made by the states and the subordinate political units "

Divisions of Public Finance

The subject of public finance has four principal divisions —

(1) Public Expenditures
(2) Public Revenues
(3) Public Debts
(4) Financial Administration

Principles regulating public expenditure

The fundamental principle regulating public expenditure is general welfare—all public expenditures are to be incurred to promote the welfare of the people in different ways The maximum result should be aimed at

Progressive states find it advantageous to assume different functions at different periods, and on the whole there is a distinct tendency on the part of the modern state to extend gradually its functions Whether it is desirable or not on the part of the state to undertake certain functions and to incur public expenditures in connection with these—in answering this question, *the statesman should not be guided by dogmatic theories* of laissez faire or dogmatic theories of paternal interference

He should be guided by a careful consideration as to whether the advantages to the society in that particular case outweigh the disadvantages, whether *the welfare of the society is on the whole increased on the state undertaking those functions*

In connection with public expenditures, certain general considerations suggest themselves

(1) The amount of public expenditures should be such as would not absorb an unduly large proportion of the income of citizens, it should not impose excessively heavy burdens upon the peopl hard and fast rule can be given

(2) Public expenditures should be economical, in a double sense (a) they should avoid waste (b) they should attempt to avoid all indirect evils (4) There should be facilities for public criticism and adequate check (5) And finally these expenditures should be elastic increasing with the resources and the needs of the state and diminishing with a decrease of resources or needs

Classifications of public expenditures

Local — Central ; provincial & Local

Many different principles of classification have been followed by different writers on this subject

I *A classification made with respect to objects of expenditure* is the following —

(a) Expenditure for national defence (viz army, navy, aircraft etc

(b) Expenditure for the poor and helpless

(c) Expenditure for education and culture (schools, universities museums, picture galleries etc)

(d) Expenditure for commerce, industry and government

II A classification made with respect to the *political units* which control the expenditure is given below

(a) Public expenditure by the central government of a country (i e., the Government of India or the federal government of the of the United United States)

(b) Public expenditures by provinces and state government (e g , the provincial governments of India or the state governments States)

(c) Public expenditures by local units e g , the Indian district boards and municipalities and corresponding political units of other countries

III *Plehn's classification*

He classifies expenditures into (a) *expenditures exclusively for the common benefit*—the expenditures for the common benefit are classified into (i) expenditure for general administration (ii) expenditure for the legislative department (iii) expenditure for public buildings (iv) expenditure for public defence (v) expenditure for means of transportation (vi) expenditure for education (vii) expenditure for assisting private industries and commerce

(b) *Expenditure for the benefit of individuals*

The expenditure for the benefit of individuals includes (i) expenditure for charities (ii) pensions for public servants (iii) bounty and protection (iv) expenditure for the administration of justice (v) expenditure for the betterment of the property of individuals (vi) expenditure in public industries

Productive & Unproductive Exp.

Public Revenues

We have next to see what are the different classes of revenues which are raised in modern states to meet the public expenditures

As there are different classifications of public expenditures so there are different classifications of public revenues by different writers

(A) Public revenues may be usefully classified in the following manner

Imp Sources of Public Revenues

(a) **Extraordinary Revenues** consisting of the public loans

(b) **Ordinary and permanent revenues consisting of**

I. Revenues derived directly from Government ownership

(a) Revenues from public domains e g land, forests, mines, etc, owned by the Government in proprietory right

(b) Revenues from public industries i e, industries owned and managed by the Government e g the post office, and many railways in India, railways in France, Japan, Germany, etc

(c) Revenues from interest, investments etc (e g the interest on the Suez Canal shares owned by the British Government)

II. Revenues derived from the incomes of private persons and corporations (a) Fees, (b) Special assessments, (c) taxes

III. *Miscellaneous revenues*, e g, patriotic gifts, fines, etc

(B) Prof Plehn classifies revenues according as they are justified (a) by common (b) or special benefit, and we have seen that he has followed the same principle in classifying public expenditures

Public domains

The revenues from public domains consist of the revenues from agricultural land, mines and forests etc owned by the state and managed in the interests of the public revenue The revenues from public domains constituted the most important source of public revenues in earlier times The oldest form of public property is land and the public land originally embraced all the territory of the state

The German states are in favour of retaining their domains in lands and forests and they derive a considerable revenue from these sources On the other hand, in England, France and the United States the policy of steadily diminishing the public domains has been and is being followed

Modern English and American writers do not favour the public ownership of agricultural land because land under public ownership (except when in charge of a highly trained body of expert officials as in Germany) does not form a satisfactory source of revenue

The public ownership of forests is however generally advocated

This is due to the fact that (a) the Government in its management of forests takes into account the interest of the community as a whole and this the private owner does not (b) the Government being a permanent institution can afford to wait for a long time for the economical use of timber land but this the private owner cannot (c) and that Government management is made practicable on account of the routine character of the business

Land nationalisation

This subject is treated in the chapter on Rent

Public Industries

Industries which have succeeded well under government management have been *generally industries of a monopolistic character* (e g the supply of water or gas in towns etc can be made to yield a considerable public revenue) Industries which are naturally competitive should be left to private hands except in certain cases where political considerations or the desire for national industrial expansion make state interference and control necessary and inevitable (Refer to Book vi, ch ii)

Fees and special assessments.

(a) † *Fees* The state in the exercise of its functions sometimes confers special benefits upon particular individuals *A fee is a payment made by a citizen to the state for some special service rendered by the state to the citizen*, and the service being largely non-commercial in character

The litigant who pays the court fee for instituting a suit in a Court derives a special benefit from the payment of that fee,—the special benefit is that he is allowed to bring his case before the Court

Some examples of fees are —fees for pass ports, fees for recording mortgages, for recording marriages, etc

Among modern progressive nations, it is found that the relative importance of fees as a source of public revenue is declining, and that a greater and greater portion of public revenue is being raised not by special contributions like fees but by general contributions like taxes

(b) *Special assessments*

A special assessment is a compulsory contribution levied upon the property of private individuals in proportion to the special benefit conferred upon the property which is improved in value by public expenditure undertaken in the public interest

In the United States of America, a city often provides for the expense of improving a particular street (a) by laying part of the cost upon the municipality in the form of a tax (b) and by raising the rest of the money required in the form of a *special assessment* upon the properties of those citizens which are increased in value by the improvements undertaken by the municipality

The advantages of the special assessment system

(1) The system of special assessment is evidently just and equitable because those persons only have to pay the special assessment who derive a special benefit in connection with their property from the public expenditure

(2) Another advantage is this The special assessment system makes it possible to carry out street improvements etc , at a much faster rate than would be the case under a system of improvements by general taxation

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† "The essential characteristic of a fee is the existence of a measureable special benefit together with a predominant public purpose " "The absence of public purpose makes the payment a price , the absence of special benefit makes it a tax." Seligman—Essays in Taxation

The disadvantages of the system

If the municipal government of a city is corrupt, then the system of special assessment will lead to extravagant expenditure and to great corruption and jobbery. Public improvements would be undertaken not for the public benefit but to give profitable employment to favourite contractors, and the expenses of such improvements being largely met from special assessments, there will not be any very close scrutiny and criticism by the general body of tax payers.

The system of special assessment has been very extensively used in the United States. It is not used in Europe at least on any considerable scale.

TAXATION.

Definition

A tax is a compulsory contribution levied upon persons (natural or corporate) for the general purposes of the Government.

Fees and *special assessments* are contributions made by persons to the Government *for special benefits* received by them; *taxes* are levied to defray the expenses of the state *for conferring common benefits* upon the citizens of the state, and not special benefits to particular persons.

Taxation is by far the most important source of public revenues in all progressive modern states. India raises almost half of her public revenues from *non-tax sources*, and this is because heavy taxation of the ordinary kind as practised in rich and progressive countries would be impracticable in such a poor country as India. In England, France, the United States and other wealthy and flourishing countries, taxation provides much the greater proportion of the public revenues.

In discussing this subject of taxation we shall have to examine *two classes of questions* (i) *Taxation in general, theories about equity (justice) in taxation, canons of taxation* etc and (ii) *Specific taxes*.

† Theories about equity (justice) in taxation

What is the ideal of just taxation? This is a question of the greatest theoretical interest and practical importance in public finance. It is a question which has engaged the earnest attention o[f]

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† Walker on the ideal tax

The ideal tax, according to Walker, is a tax on faculty. Faculty (the powe[r] of production) constitutes the only theoretically just basis of contributio[n]. Suppose a work of general concern requires to be constructed. All able-bodie[d]

economists and statesmen all over the civilised world There are numerous theories on the subject and the most important of these are given below

(i) The benefit theory

This theory maintains that justice in taxation is secured by taxing each citizen in proportion to the benefit he receives from the activity of the state

The benefit theory is open to the following objections

(a) The weak and the poor receive the greatest benefit from the Government They get free education and are, if necessary, maintained at the government expense Though they receive the greatest benefit they are however least able to bear the burden of taxation, and it would be unjust and immoral to tax these poor men in proportion to the benefits received by them

(b) Again as regards different classes of society it is impossible to point out exactly what proportion of general benefit goes to particular individuals So taxation in proportion to benefits becomes impracticable

(The benefit theory really applies not to taxes but to fees and special assessments which are levied in proportion to benefits received by persons making these payments)

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person should turn out, and each man work according to his faculties, in the exact way in which he could be most useful This is the form of contribution which is prevalent in all primitive communities, and the largest tax of modern times viz compulsory military service is assessed and collected on precisely this principle

Walker admits that the faculty tax though it is the ideal tax is impracticable as the sole tax, in a complicated condition of industrial society Hence we have the different taxes on expenditure, on income, on capital etc

Purely 'Economic' theory of taxation

This theory boldly proposes to abandon altogether the attempt to follow out the equities of contribution Walker sums up the theory thus "Why make the hopeless effort to apportion the burdens (of taxation) with absolute justice? Get the best government you can, maintain it at the least expense consistently with efficiency, collect the revenue for the service by the most convenient simple and inexpensive means' And in this connection, Walker quotes McCulloch "The distinguishing feature of the best tax, is not that it is most nearly proportioned to the means of individuals, but that it is easily assessed and collected and at the same time, most conducive to the public interests"

(ii) The equal sacrifice theory

Many writers maintain that taxation to be just, should cause *equal sacrifice among the taxpayers* Equal sacrifice is taken here to mean *equality of proportional sacrifice* and not equality of absolute sacrifice In other words the tax payers after payment of the tax should occupy the same relative positions which they occupied before they were taxed (So according to the equal sacrifice theory taxation should be so framed that the marginal utility of income of different tax payers is affected in an equal degree by the taxation imposed)*

This theory accepts the existing distribution of wealth as just and it holds that taxation to be equitable should leave present distribution undisturbed by imposing a proportional sacrifice upon the tax payers

(iii) The faculty theory

Most economists are of opinion that justice in taxation can be secured by following the *faculty or ability principle* Taxation should be levied upon persons in proportion to their faculty or ability to pay and not in proportion to benefits received by them

In theory it is perfectly just that men should be made to help the state revenue in proportion to their power to help themselves

Persons who can earn large sums for themselves and so have ability to pay heavy taxes should be made subject to heavy taxation though these persons may not derive much direct benefit from the taxes , and the poorer classes who cannot earn much for themselves have comparatively less ability to pay and so they should be taxed lightly though they may derive much direct benefit from the proceeds of taxes *Faculty is a better criterion than benefit*

Now how is faculty to be measured ?

(a) Some suggest that faculty is to be measured by *consumption* This view is not satisfactory because the consumption of the

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* By equality of taxation, some economists mean that taxation should involve this equality of sacrifice on the part of the tax-payers. As Ely points out however, equality and uniformity in practical application have come to mean little more than this, that taxation shall not be arbitrary, capricious, or plainly unreasonable, and that within each class of persons or objects the burden shall be equal

poorer classes is greater than their ability to pay and the consumption of the richest classes is less than their power to contribute to the state revenue

(b) Again other people suggest that *property* is the true measure of ability The objection to this is that property differs greatly in productiveness, and that a man with a small property may have a large income and consequently great ability to bear taxation

(c) Then there is the view that *income* is the best measure of ability This is the view least open to objection and most widely accepted

Of course income as a measure of ability is not completely satisfactory in every way This is because equal incomes are not equally permanent and so do not measure the same ability, and also because of two persons with equal incomes, one may have a larger family to support and so may have less ability to bear taxation

It is impossible however to find a better single measure of ability than income, and the only course open to us is to levy taxes on income or revenue and in cases where it leads to injustice to remove the injustice, either by varying the rate of the tax or by inheritance taxes and in other ways

Progressive and proportional taxation P.

If the rate of taxation remains the same for all incomes (or property) large or small, then we have *proportional taxation* [When there is a proportional tax of 3 p c on incomes, then an income of Rs 300 would pay Rs 9 ($3 \times 3 = 9$) as taxes, an income of Rs 500 will pay Rs 15 ($5 \times 3 = 15$), an income of Rs 1000 will pay Rs 30 ($10 \times 3 = 30$) and so on]

If the rate of taxation increases as the income (or property) increases, then we have *progressive or graduated taxation* [Suppose the rate of taxation is 3 p c for Rs 100, 4 p c for Rs 1000, 5 p c for Rs 10,000 and higher rates of taxation for larger incomes then we have progressive taxation]

We thus have *proportional and progressive taxation of income*, and also *proportional and progressive taxation of property*

Justice in taxation is attained by levying taxes according to the faculty of tax payers

The faculty theory leads directly to the question of progressive and proportional taxation *Now which is the better measure of faculty? A proportional rate of taxation or a progressive rate of taxation?*

Regressive and Degressive taxation

If the rate of taxation diminishes as the income or property increases we have *regressive taxation* and if the rate of taxes increases faster than the income or property but towards a fixed maximum rate which it can never exceed it is known as *degressive taxation*

The argument in favour of progressive taxation

Progressive taxation is a better measure of faculty than proportional taxation

Most economists are agreed that the *ability* of a person to pay taxes *increases more than in proportion to the increase of income or property* and so following the ability theory, the rate of taxation should be higher for larger incomes or larger properties The *justice of progressive taxation* follows naturally from the ability or the faculty theory

Arguments against progressive taxation (and in favour of proportional taxation) **and an examination of these arguments** The opposition to progressive taxation is based partly upon an objection to the principle of progression and partly upon administrative difficulties connected with it

Progressive taxation wrong in principle

(1) Some critics say that a progressive system of taxation with its higher rate for the upper classes is socialistic Progressive taxation regards the existing system of the distribution of wealth as unjust while as a matter of fact, the existing system is just and should not be disturbed So the progressive system is wrong in principle

And also wrong in its method

(2) Even if it be admitted that the present system of the distribution of wealth is defective, the defects should be remedied not by taxation but by more direct methods dealing with the root causes of existing inequalities Better educational facilities for the people, proper control of monopoly industries and a provision for wider industrial opportunities are much better instruments for removing the defects of the existing system of distribution than any system of progressive taxation

Writers who do not regard progressive taxation as socialistic and who are not opposed to removing some parts of the existing inequalities by taxation, some of these writers point out other objections to the application of the progressive principle

(3) *Progressive taxation*, it is maintained, *would check the accumulation of capital* (The answer to this is, that even a proportional tax will check to some extent the accumulation of capital, and hence this argument against progressive taxation is more or less an argument against all taxation in general The argument is not therefore of much practical value)

(4) *A progressive tax would be but slightly more productive of revenue than a proportional tax* and so there is no necessity for a progressive tax (This is an argument used by some opponents of progressive taxation The answer to this is, (a) in many cases progressive taxation will mean a much larger revenue (b) and even in that case where it is only slightly more productive than a proportional tax, yet it will fall to a greater extent on the richer classes and less on the poor classes and will thus secure a larger measure of justice for the masses)

(5) Another argument sometimes advanced in favour of proportional and against progressive taxation is that *a progressive tax would lead the richer classes to make false statements about their income so as to avoid the higher rate*

(The defenders of progressive taxation reply that persons who are capable of making false statements will attempt to evade proportional as well as progressive taxes, and so the objection does not apply to progressive taxation alone),

(6) Another argument put forward against progressive taxation and in favour of proportional taxation is that *a proportional tax is uniform whereas a progressive tax has a varying rate* and the variation of the rate is arbitrary and capricious (We may answer to this, that all taxation is more or less arbitrary in this sense, the rate of taxation being fixed not by any natural law but being determined by the ethical judgment and the common sense of the government)

An examination of arguments advanced against progression thus shows that the objections against progression are very far from decisive and indeed go to support the case in favour of progression The progressive system is not only theoretically just, it is practicable and its administrative difficulties are greatly exaggerated

A moderate degree of progression should be aimed at Very high progression will be perhaps unjust, will arouse great opposition from the rich and propertied classes, check the accumulation of capital, slacken the energies of industrial leaders and retard industrial progress

The subsistence minimum must be exempted from taxation

The aim should be progression for the taxation system as a whole—stronger progression might be necessary in the case of one tax so as to counteract the injustice and injurious effects of other taxes

The enormous expenditures of the last war have brought about a great extension of progressive taxation

Canons (or principles) of Taxation

Every country must carefully adjust its taxation system (indeed its entire system of revenues and expenditures) to its economic, political and social conditions, its moral ideals, its history and in some degree even to its prejudices The chief canons or general rules relating to taxation are the following

(1) *The principle of sufficiency.*

The taxes must be adequate so as to raise a sufficient revenue for the state——an annually recurring deficit is a great political and economic evil and it must be prevented If the revenue required for enabling the state to discharge its proper functions, if this revenue cannot be raised by good taxes it will be necessary to levy even some taxes of somewhat inferior quality— —this has to be done in war time and other periods of stress

(2) *The principle of equity (justice) in taxation.*—All writers are agreed that equity in taxation is a fundamental requisite the burden of taxation should be distributed equitably among all classes of the population Now how is justice in taxation to be secured? Economists and financiers are by no means unanimous on this point but the opinion most widely accepted among modern economists is, that *equity (justice) is best secured by following the ability or the faculty principle* Persons should be taxed by the state in proportion to their ability to contribute And for this progressive taxation is necessary

(3) *The principle of economy*

This principle declares that other things being equal those taxes

are most suitable and should be chosen (i) the *cost of collection of which is small* in proportion to the revenue, produced by the tax (ii) the indirect loss occasioned by which to the country is small in proportion to the proceeds of the tax (A tax which would require a large number of officers to supervise the collection of the tax would be expensive and would be opposed to the principle of economy *Taxes which hamper production or injuriously affect consumption are against this principle of economy.* A tax upon an industry, subject to the law of increasing returns, would cause a considerable loss of consumer's surplus to the country and would be thus opposed to this principle Taxes upon the consumption of injurious articles e g alcoholic liquors and other intoxicants would diminish the consumption of these things and would be quite in accordance with the principle of economy

Also as far as possible, taxes should be so selected as to cause the least possible amount of inconvenience to the tax-payers as regards time and mode of payment etc —

(4) *The principle of clearness.*

Taxes should not only be equitable, economical, convenient, they should also satisfy the principle of clearness

The principle of clearness maintains that taxes should be framed in such a manner that people who have to pay taxes should be able to know without difficulty *what* they have to pay, *when* they have to pay and *why* they have to pay

5 *The principle of variety*

Every tax tends to bear unjustly upon some particular class of people , so there should be variety in the matter of taxes, there should be different kinds of taxes, neutralising the defects of one another

6 *The principle of elasticity*

A country has sometimes to increase its public revenues to meet a temporary or a permanent increase in the public expenditure The tax system of a country as a whole should be elastic in the sense that the total tax revenue can be increased within reasonable limits by increasing the rates of all or some of the taxes of that system, without altering substantially the distribution of the burden of taxation upon the different classes of the people Elasticity is not only desirable in any particular tax, it is eminently desirable in the tax system as a whole

Direct and indirect taxes

Direct taxes are taxes which are levied upon the persons who are expected to bear the burden of these taxes and who are not expected to be able to shift the tax burdens to other persons. In other words in the case of a direct tax *the tax-payer is also the tax-bearer* at least in the expectation of the law giver. (If the Government levies a tax upon the income of its servants and collects the tax by deducting it from salaries then the tax levied upon the Government officials is also ultimately paid by them. This tax upon the incomes of these officials cannot be shifted by them to other persons and so it is a direct tax.

Indirect taxes are taxes which are imposed upon persons who are expected to shift the burden of the tax to other persons.

(Suppose the Government imposes a tax upon books imported from abroad, and the book sellers realise the tax which they pay to

[illegible] sell in the books at higher prices, then the tax [illegible] (The tax is imposed upon the book-seller but it is shifted [illegible] the book-buyers.)

[illegible] are the land taxes, the building taxes, property [illegible] poll tax [illegible] income taxes; the indirect taxes are [illegible] fees and licenses.

[illegible] between [illegible] since many taxes which seem [illegible] are regularly shifted to others.

Advantages [illegible] Disadvantages of Direct taxes

[illegible]

(i) [illegible] proportionate to income or property and [illegible] more equitable than indirect taxes.

[illegible] direct taxes alone, the important principle of graduation [illegible] can be applied to income or property according to amount and source etc.

(ii) Another advantage attaching to direct taxation is that it is [illegible] and so there is less chance of evasion.

(iii) The taxpayer also knows [illegible] what he has to pay and [illegible]

So [illegible] are compelled to be economical and careful. "If you had only direct taxes, you would have economical government" (Gladstone).

Disadvantages

(i) Direct taxes being directly paid by the tax-payers are more felt and so are more unpopular than indirect taxes.

Another difficulty is the necessity of assessment in all direct taxes [illegible] there must be a valuation of the object upon which it is charged and this gives opportunity for evasion and for arbitrary official action.

With the progress of society and education, people will come to see that direct taxation is really more just and economical than indirect taxation through increased price of commodities, and then the unpopularity of direct taxation will decrease.

It is also sometimes said that direct taxation is expensive.

(iii) It is also sometimes said [illegible] and does not grow in proportion to the increase of national wealth.

This is not correct as the English income tax has produced a large and expanding revenue

† Advantages and Disadvantages of Indirect Taxes

Advantages —

Indirect taxes are strong exactly in those points in which the direct taxes are weak

(*i*) Indirect taxes being paid indirectly by the tax-payers are not so much felt and therefore are more popular than direct taxes.

(*ii*) One great advantage is that indirect taxes on commodities, etc, are paid by men when they spend, (not when they earn or save) So accumulation of capital is not discouraged

(*iii*) Again indirect taxes on commodities are collected at a convenient time, since the taxpayer pays the tax when he buys the commodity and he is at liberty to escape the tax by not buying the commodity

(*iv*) In times of prosperity, indirect taxes are productive and elastic without pressing too heavily upon the people

Defects of indirect taxes —

(*i*) The greatest defect is that indirect taxes on articles of general consumption press more heavily upon the working classes than on the richer classes, *this is not equitable* (This evil can however be diminished to some extent by taxing articles of general consumption and by levying higher duties upon superior qualities of the articles taxed)

(*ii*) At times of depression, the revenue from indirect taxes often shrinks

(*iii*) Increased rates sometimes produce stationary or even diminished receipts

(*iv*) Expenses of collection are sometimes larger in the case of indirect taxes than in the case of direct taxes

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* After-war Problems

Our Money and the State (Hartley Withers)

(4) Other serious objection to the indirect taxation of commodities is the loss to society through the disturbance of industry. This evil can be reduced to an important extent by suitable regulation and precaution.

An examination of the merits and defects of direct taxes shows that in modern times direct taxes should form a predominant part of every well-organised tax system—direct taxes consisting of the income tax, [illegible] duties, legacy duties etc. Indirect taxes also have to be included in every tax-system along with direct taxes. But reliance on indirect taxation to a great extent will be unjust to the poorer classes and at times of depression will cause serious financial difficulties.

As a matter of fact in rich and progressive countries like England, indirect taxes on account of their heavy burden on the poorer classes and other defects are being replaced more and more by direct taxes. In 1873 indirect taxes produced about three-fourths (73 p.c.) of the total tax revenue of England and in 1916-1917, they were expected to yield 34.6 per cent only, the remaining 65.4 per cent being produced by direct taxes.

Customs taxes

Customs duties are taxes imposed upon commodities when they cross the boundaries of a state or of a customs union, (composed of two or more states.)

Customs taxes are of two kinds:

(1) *Protective customs duties* (2) *Revenue duties*

Protective customs duties are taxes levied upon imported foreign goods primarily with the object of diminishing foreign competition with a corresponding domestic industry. A country imposing protective customs duties is said to have a *protective tariff*. *Revenue duties* are customs duties which are imposed primarily for securing a revenue for the Government and not for protecting a domestic industry. A country imposing only revenue duties is said to have a *revenue tariff*—England has got a revenue tariff and so also India (with some elements of imperial preference recently introduced). Almost all other large and powerful modern countries France, Germany, Russia and the United States etc. have got protective tariffs.

There is a fundamental opposition between revenue and protective

principles. For a duty to be adequately protective must shut out foreign imports and then very little revenue will be raised by such a duty. (The tariff of a country does often contain some protective duties and some duties which are mainly for revenue. This is the case in the United States and also in many other protectionist countries.)

Some of the most *useful qualities in customs duties* are (1) high productivity (2) cheapness of collection (3) stability and responsiveness to the control of the treasury. These virtues are to be found in a larger measure in revenue duties properly selected than in a comprehensive and complicated system of protectionist duties. [Duties levied upon the value of the imported commodities are known as *ad valorem duties*; duties levied according to weight, bulk or other units of measurement (and not according to value) are known as *specific duties*. Obviously specific duties fall most heavily upon the coarser or cheaper grades of commodities. Ad valorem duties are however open to the objection that they offer a greater temptation to business men to make fraudulent valuation and thus to evade a part of the taxation.]

Internal revenue duties

Internal revenue duties largely consist of excises. Excises may be defined as taxes levied on commodities produced within the country and destined for home consumption.

(1) Defects

Excise taxes suffer from the following defects,—

(I) As these taxes are levied generally on articles of general consumption consumed even by the masses of the people, and as they are shifted in a large degree to the consumers, these taxes frequently weigh more heavily upon the poor than upon the rich. This is inequitable.

(II) Another defect of these duties is, that in some cases they involve detailed supervision and interference with the taxed industry, and this is unpopular and also not very desirable.

(II) Prof. Ely points out that such interference with the industry is borne better and with less effort by large scale business than by small scale business and hence internal revenue duties exercise an influence in the direction of large scale production and perhaps of monopoly. (The influence exerted by the internal revenue duties in these directions seems however to be rather exaggerated by Prof. Ely.)

(IV) Excise taxes often exercise little beneficial influence upon the consumption of articles the use of which is believed to be harmful to the consumer. This is because a high excise tax upon such commodities will often lead to adulteration instead of high price and diminished consumption.

Merits

According to Prof. Ely, internal revenue duties if properly selected have the following advantages: (1) They are highly productive. (2) They have a considerable amount of elasticity in rich and progressive countries. (3) The expense of collection is small. (4) The burden of internal revenue duties is generally shared between the producer and the consumer. (It must be remarked here that these duties are productive and elastic only in rich and progressive countries. In a poor country and during a time of depression, these duties will neither be highly elastic nor highly productive.)

Taxation of Commodities

Taxes on commodities are indirect taxes, and they have the usual defects of indirect taxes.

In levying custom or excise taxes on commodities, the general principles already discussed (pages 264-265) should be borne in mind.

(I) The taxation of necessaries should be avoided as far as possible as such taxation weighs very heavily and unjustly upon the poorer classes. When the need for revenue is very great, taxation of necessaries cannot be avoided, but to secure an equitable distribution, heavy taxes on the luxuries of the rich should be imposed at the same time. A prominent example of taxation of necessaries consists in food taxes.

Food taxes

Taxes on the food of the people are (1) bad from the moral standpoint because such taxes impose a cruel burden on the poorest classes (2) bad from the economic and financial standpoints because these taxes lead to starvation, underfeeding, and thus to economic inefficiency and disease specially among the lower grades of workmen, increase of the pauper population and higher taxes to maintain them.

So taxes on food must be always avoided, if possible. Food taxes, bad as they are, have to be levied often in war time when the need for revenue is extremely urgent and also in very poor countries where the required revenue cannot be raised otherwise.

(II) Taxation of *harmful luxuries* and other *injurious articles of consumption* (e g alcohol, opium) is generally advocated on the ground that such taxation will check harmful consumption and will at the same time secure a revenue for the Government

(III] As far as possible the taxation of *commodities, the demand for which is elastic*, should be avoided Taxation of such commodities brings about a large contraction of demand and a large loss of consumer's surplus to the people

These are the points to be taken into consideration from the standpoint of consumption

(IV) The taxation of *commodities subject to increasing returns* is undesirable as such taxation will make the people miss the advantages of increasing returns

(V) *Commodities* the supply of which is *monopolised* are fit subjects for taxation because such taxation will generally fall on the profits of the monopolist (A lump sum tax on a monopoly and also a tax proportionate to the monopoly revenue are paid by the monopolist out of his own monopoly profits, and the consumers escape the tax)

(VI) *Import duties* are most profitably imposed on commodities for which the country has a monoply of demand or the production of which is monopolised or is subject to increasing returns in the foreign country producing the commodity In these circumstances, a part or the whole of such duties would be paid by the foreign country

(VII) *Export duties* are best levied on commodities of which the exporting country has got a monopoly of supply A good example is jute exported from India Export duties in such cases will be paid by the foreigners to whose countries the commodities are exported

General Property Tax

A general property tax is a tax which is levied on the entire amount of the property, real and personal, owned by the payer It is used in Russia, Holland, Switzerland but it is used more extensively in the United States than in any other country The general property tax has been universally condemned in the United-States and this condemnation is chiefly due to the fact that it is not properly supplemented by other taxes

The Income Tax

The income tax is based upon the income of the taxpayer. We have the income tax in England, India, Italy, in the German States, Austria and Switzerland, and income taxes have been proposed in the United States and France.

The ideal income tax (a) should exempt all savings from taxation — for savings form the source of future capital and property is to be taxed by taxes on inheritance and in other ways; (b) should be properly graduated according to faculty — small incomes must be exempted, moderate incomes are to be taxed at moderate rates, and large incomes at higher rates. The tax should be graduated also according to the number of dependents upon each income.

Exemptions from the income tax

Small incomes are generally exempted from the income tax (a) partly because the possessors of such incomes pay their due share and even more than that through other taxes; (b) partly because the expense of collection would be disproportionately high and also the unpopularity of the tax would be very great among the poorest classes.

*** Merits**

An income tax has the following merits:

(1) It is *equitable*. We can measure ability better by income than by wealth or consumption or any other single standard.

(2) It is *productive*, and experience has shown that it *gains in economy and productiveness* and becomes more and more popular as the years pass on.

(3) It *cannot be shifted* easily if at all, and so there is little trouble due to shifting.

(4) A most useful feature of this tax is its admirable *elasticity*. In good times when the customs and excise taxes are productive, a reduction in the rate of the income tax will enable the Government to avoid an excessive surplus. At times of depression when the revenue from other taxes falls off, a rise in the rate of income tax will enable the Government to increase its revenue to the required extent with a minimum disturbance of industry and capital.

* Mr Hartley Withers waxes enthusiastic over an ideal income tax and since we are only chasing the rainbow of the ideal, we may also add that in order to make the income tax perfect, it would, though assessed on the whole income, only be imposed on that part of a man's income which he spends and

This elasticity makes the income tax admirably fitted for the position of the central tax of the revenue system and its regulator. And this is the function performed by the income tax in England.

Disadvantages

The income tax has, however, certain disadvantages.

(1) It is generally *unpopular, specially when it is first introduced.* People do not like the searching enquiries which are necessary to ascertain the income upon which the tax should be assessed.

(2) The principal objection to the income tax relates to *difficulties in its administration.* In calculating the net income upon which the tax is to be imposed a large number of deductions has generally to be made from the gross income, and there are practical difficulties in determining the amount and the kind of these deductions.

The income tax has great and outstanding merits and these disadvantages are of a comparatively minor character. And a suitable income tax carefully framed so as to minimise the disadvantages should form a part and an important part of the tax system of every country.

Inheritance tax

A favourite and very productive form of taxation in recent years is the taxation of inheritances, collateral or direct. The usual practice is (a) to tax bequests to the distant relations at higher rates, and also (b) to make the rate high for large and small for small inheritances.

Merits

The inheritance tax has the following merits.

(1) It is in conformity with the faculty theory. A man's ability to pay taxes is obviously increased when he inherits property, and the larger the inheritance the greater is the ability. (2) Such a tax is easily collected, and without much expense.

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he would be allowed abatement in consideration of any part of it that he invested and not only—as now—in life insurance." (Our Money and the State.)

Professor Marshall offers the following remarks on an ideal income tax: "If it were possible to except from the income tax that part of income which is saved, to become the source of future capital, while leaving property to be taxed on inheritance and in some other ways: then an income tax graduated with reference to its amount and the number of people who depended for support on each income, would achieve the apparently impossible result of being a graduated tax on all personal expenditure. The way to this ideal perfection is difficult: but it is more clearly marked than in regard to most Utopian goals."—Afterwar Problems.

A progressive inheritance tax has been introduced in England. A high degree of progression is advocated by reformers. Bequest to distant relatives seems to be a survival of the sentiment of past times when even distant kinship was a stronger bond than common citizenship in a city or a state. Such sentiment is now declining in force and intensity and there is every likelihood that bequest to distant relations will be largely curtailed by modern legislation and in favour of the state.

In England, after the war an increase of inheritance taxes will be necessary and also desirable. And a progressive tax on inheritances is wanted in India to lighten in some measure the burden of taxation on the poorer classes.

Poll taxes

Poll taxes are taxes which are usually imposed at a uniform rate upon all male citizens.

Such a tax bears more heavily upon the poor than upon the rich and is thus inequitable and it is difficult of collection and generally very unpopular. For these reasons, poll taxes are disappearing from the tax systems of modern states.

* Incidence of Taxation P

To understand the subject of incidence, we must distinguish between the *incidence* and the *impact* of a tax. The *impact* of a tax is upon the person from whom the tax is collected, and the *incidence* upon the person who pays it ultimately.

Suppose a tax is imposed upon a commodity imported from a foreign country. The government will collect the tax from the foreign

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* The theory of the Repercussion or Diffusion of Taxes.

This theory favours indirect taxation and holds that the state should lay its contribution on articles of general consumption as are most easily reached, or on such of the processes of production or exchange as lie most open to view, trusting to the laws of trade to distribute the burden over the whole body of the population. The diffusion theory of taxation is based upon the assumption of perfect competition and it will be true only when there is complete mobility of all economic agents.

As a matter of fact, we have imperfect competition, and we have not complete mobility of economic agents and so the theory is not true, it is not in accordance with facts. And as the burden of taxation is not naturally distributed by the laws of trade over the whole body of the population, so the financier has to be careful as to the places and persons where and on whom the burden shall be laid or he will run the risk of committing injustice. The financier must regard himself responsible for the ultimate incidence of the taxes.

er but the foreigner will generally raise the price of his commodity on account of the tax, and in some cases will recover the whole amount of the tax from the domestic consumer In these cases, the incidence of the tax is upon the domestic consumer who ultimately pays the tax

By the term *shifting* is meant the transference of the burden of a tax from the payer to some other person or persons In the case mentioned above, the tax is said to be shifted to the consumer from the foreigner who pays the tax at first The process of shifting is also called *repercussion* of taxes

The subject of shifting is a very important one, and statesmen and financiers have to be particularly careful that their objects in framing a tax system and their attempt to establish justice in taxation are not frustrated by the shifting of the taxes they impose

Elasticity of supply

The chief factor controlling the incidence and the shifting of taxes is mobility or elasticity of supply, and this mobility depends upon the scope of the tax and upon the existence or non-existence of monopoly or differential advantages

A tax universal in scope cannot be easily shifted A tax levied upon mortgages within one particular area can be shifted by the mortgagee because he can invest his capital in other ways and thus can escape taxation

Incidence of different kinds of taxes

(1) *Taxes on economic rent* and other differential advantages

Incidence of taxes on pure economic rents falls upon persons, who receive the rents This applies to economic rent of land and to all true rents including personal rent

Economic rent does not enter into cost of production (and price) of the commodity, and a tax on economic rent cannot be shifted to purchasers of the commodity.

(2) *Tax on interest*

( ) *Tax on interest in general*

If interest in general is taxed then the net yield of capital is diminished The reduction in the net yield of capital in a country discourages the accumulation of capital in that country, and it also leads to the exportation of capital to other countries where the net yield is higher This check to the supply of capital in the country

uses the marginal utility of the capital and thus raises the rate of interest The tax on interest is thus shifted to the borrower by the elasticity in the supply of capital

(b) *Tax upon particular kinds of interest,*

If a tax is levied upon interest on mortgages and not upon other kinds of interest and if the tax is imposed upon the lender, he will easily shift it to the borrower The lender can evade the tax on mortgage interest by lending in other ways and so here the borrower will have to pay the tax —the incidence of the tax will be upon the borrower.

3 *A tax on buildings*

If the supply of houses is larger than the demand, the incidence of a tax on buildings will be on the owners of these houses When the supply of houses is limited, then the owner will be able to shift the tax to the tenant

4 *Poll-tax and wages taxes*

Poll-taxes cannot be generally shifted, the only case in which the poll-tax can be shifted is, when it is levied upon a wage-earner on the point of starvation A tax on wages generally falls on the workmen, specially if the wages are high If the tax affects the efficiency or supply of labour, then the wage-earners will be able to shift a part or the whole of the tax to the profits of the employers or to consumers in the form of increased prices

5 *Tax on profits*

A tax on profits if extending to all profits, will be generally borne by the producers A tax on profits, if confined to the profits of some particular occupation, will be borne by the consumer

6. *Income tax*

A general income tax consists of a combination of taxes on the separate ingredients of income—rent, interest, profits, and wages, and the incidence of the income tax must depend on the laws applicable to each separate part Speaking broadly it cannot be shifted *if the assessment is general and uniform*, but as a matter of fact such a tax is rarely general or uniform

7 *Customs duties and excise taxes*

(a) Excise taxes and import taxes

The incidence of excise taxes and import taxes is generally upon the consumer These are sometimes shifted to the producers

(1) if the taxed commodity is produced as a monopoly and the price is already as high as the traffic will bear (2) if a new tax is levied on some commodity produced by a large plant of fixed capital

§ 8 *Taxes upon monopolies.*

(i) *A fixed (lump sum) tax upon a monopoly* and (ii) *also a tax proportioned to the monopoly revenue rest upon the monopolists,* (unless the tax is so high as to reduce the monopoly profits below the amount that can be earned in a competitive industry) Such taxes cannot be shifted to purchasers of the commodity ~~because~~ the monopolist cannot alter the supply—he has already fixed his production at the amount which gives him a maximum gain and an alteration in the supply (and price) will reduce his net gain

(iii) *A tax in proportion t ... produced by the mono- ... can be shifted by him ... supply* As the tax is proportioned to the supply ... on of supply will involve reduction in the amount of tax ... by the monopolist

[*Are old taxes the best taxes*

It is sometimes said that o... are the best taxes Now as a matter of fact *old taxes* ... *the best taxes*——heavy taxes on the food of the pe... otherwise protectionist duties are bad taxes whether they are o... Bad taxes do not become good only because they have ... old

Old taxes have however cer... advantages——the people have grown accustomed to them ... the injuries caused by them have been diffused among the p... and in some cases the capitalisation of a tax may have remove... the burden altogether]

Deflection Amortisation

According to Pierson taxation is said to be deflected when the pressure is either (a borne in part by the foreigner (b) or avoided altogether Amortisation of a tax means its capitalisation—in a case of amortisation the property taxed has its value depreciated by the capital value of the tax

The Public Debt

All large modern states have ... of large national debts contracted (1) *chiefly on account of wars and* (2) *partly on account of* extraordinary expenditures in connection with *public works and public industries* Prof Plehn calculates that the national governments of the civilised

Modern states have large public debts

world owed in 1908-1909 the huge total of 7500 million sterling (£7500,000,000) This huge total has been multiplied manifold (ten times perhaps) by the enormous expenditures of different nations in the last war and problems relating to the public debts of nations are engaging in an increasing degree the serious attention of nations and their governments

In primitive society where commerce is small and manufacture scanty governments make provision for future emergencies by hoarding from surplus revenue and not by borrowing from the people These early governments have hoarded state treasures and they have no national debts The growth of manufactures, and commerce and the development of credit, make it possible for a government to meet special emergencies like wars etc, by borrowing from the public and thus the system of national debts comes into existence Prof Bastable has shown how this development goes hand in hand with the development of constitutional government

State borrowing has replaced the earlier system of hoarding by the state for special emergencies

Present theory

Present theory does not regard public debts as inexhaustible mines of gold to be exploited at pleasure, nor does it condemn all public debts with indiscriminate censure It recognises that *in moderation, within certain limits, public debts are necessary and also desirable* Now what are these limits?

The present financial theory is that (a) the *ordinary expenditures* of a state (those expenditures, which recur with sufficient regularity, so that they can be foreseen and estimated in advance) are to be met *from the ordinary revenues* which include receipts from public domain, public industries, fees, taxation,—or the state will become bankrupt (b) and that the state should be allowed to meet *extraordinary expenditures* in connection with (1) special emergencies like wars (2) productive public works, e g, state railways, irrigation works, municipal gas works, water works, etc *War expenditures may be met partly from taxes and partly from loans, but expenditures on productive public works should be from loans* only, and not from taxes—taxation for this purpose would mean an unnecessarily high level of taxation and would not be generally justified (3) The state may also borrow to meet a tem-

The state should be allowed to contract public debts (1) for special emergencies like wars (2) for public works and (3) for a temporary necessity

porary necessity as when there is a deficit in the budget, the revenue of the year falling short of the expenditures for that year

It is clear what kind of expenditure is to be provided for by public borrowing and what kind of expenditure is to be defrayed from the ordinary revenues And normally taxes should not be so heavy that they cannot be paid easily out of the annual income of the nation If taxes have to be paid from the national capital, they will disturb and disorganise industries The state may borrow capital from its subjects to meet its own needs but this it should do by borrowing the national uninvested capital and not by taxing invested capital and disturbing industries [Prof Ely points out that the function of loans thus becomes a double one The distribution of unavoidable losses due to wars, floods etc, so that industry is as little disturbed as possible and (2) the investment of national uninvested capital in productive public enterprises]

The different forms of Public Debt

The two important forms of the Public debt are

(A) The temporary, *floating (or unfunded) debt* which is an advance to the government repayable by the government on the demand of the creditor, or within a comparatively short period

Floating debts suffer from two disadvantages—(a) they exercise a disturbing influence on the money market (b) they are a source of embarrassment to the government because it is precisely at a time of difficulty that the strongest demand for repayment is likely to be made

It is therefore an established financial maxim that the amount of a floating debt should be kept within narrow limits

(B) *The perpetual debt* which is contracted without any date for repayment but repayable at any time at the pleasure of the government It is in this shape that a great part of the debts of England, France, Italy and the German states exists

The system of perpetual debt offers many important advantages to a government

(i) The borrowing state is relieved from the risk of a sudden demand for the repayment of capital and has only to provide for the periodical payment of the interest on the capital

(ii) The state again is always able under this system to reduce as much of the debt as it wishes and has the power to repay and at the time most convenient to itself

The creditor is also under no serious disadvantage because at any time he can realise the capital value of his loan by selling his stock in the stock market

(C) *Other miscellaneous forms of Public Debts*

Life annuities, terminable annuities, debt redeemable by annual payments, are all useful forms of Public Debts under suitable conditions

Another classification of Public Debts divides public loans into two classes (1) forced or compulsory loans, (2) voluntary loans on business principles Professors Adams and Bastable mention a third class viz, patriotic loans Patriotic loans are however only a kind of voluntary loans, and should be regarded as such Compulsory loans were favourite devices with sovereigns in earlier times An inconvertible paper currency is on the whole an expensive, dangerous and unjust form of compulsory loan The injustice and the inconvenience attaching to forced loans ought to exclude them from the list of fiscal expedients to be allowed in a modern state Patriotic loans are also open to economic and political objections In modern states, voluntary loans issued on business principles thus constitute the only eligible method for raising funds by borrowing

Issue of a Public Debt

The following considerations are to be borne in mind by the financier when he is going to issue a public loan

(A) He will have to consider carefully the objections against public borrowing so that he might see whether he is justified under the circumstances of the case in disregarding these objections and issuing a loan (b) *And he should attempt to raise his loan in a way so to avoid as much as possible the evils attaching to public borrowing*

Objections to public borrowing.

The weight of objections to public borrowing largely depends upon the purposes for which the money is borrowed If the borrowing is for extravagant, wasteful expenditure or for the ordinary anna expenses of the government, then borrowing is not justified and if it is for proper objects (i e for necessary expenditure on wars, on public works or for a temporary necessity) then *prima facie* it is justified Other objections to public borrowing have been classified under the heads of their political, social and industrial effects

(1) *Political*

(a) The result of borrowing is to conceal from the nation the full financial effects of the policy of the government Taxation instead of borrowing would make the effects quite clear to the people by increasing heavily the tax burden

(In answer to this it may be pointed out that after a certain point, increased taxation is impossible and the state has no other alternative but to borrow to meet its expenses)

(b) In the case of weak states the autonomy of the state may be endangered by the contraction of foreign loans* This has been the unhappy experience of many states in Asia

(2) *Social*

The existence of the public debt is one of the means by which the richer classes may keep their wealth intact and increase it and may perpetuate the class distinctions and conflicting interests which result from inequalities of wealth

(The influence of the public debt in maintaining and intensifying the unequal distribution of wealth among different classes seems to be exaggerated)

(3) *Industrial*

Public loans may divert capital from productive industries and thus injuriously affect the industrial future of the country (When there is a war, entailing enormous expenditures, the revenue from taxation should be increased to the highest limit to which it can be raised without prejudicing industry, and in this way a part of the extraordinary expenditure is met from additional taxation and then a loan should be raised to defray the rest of the war expenditure [illegible] *should be taken as far as possible to see that the loan takes [illegible] uninvested capital and does not divert capital from productive industries* In this way the objection from the industrial point of view may be to some extent met)

(B) The financier has to be careful also about the *manner* in which the debt is to be contracted

(1) It has been seen that floating debts disturb the money market, and also are inconvenient for the government in certain respects so floating debts should be kept as small as possible, and

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* Loans versus Taxes during a War

Ricardo maintained war expenditure should be met entirely from taxation [illegible] Pierson held the view that war expenditure should be met from loans (and not from taxes)——but the last European war has shown conclusively the [illegible] under modern conditions *Governments have to borrow and also to increase taxation*

During the course of a great national war taxation should be largely increased [illegible] such a time (*a*) taxation is easily raised with the help of patriotic [illegible] (*b*) taxation at such a time is little if any hindrance to industry and (*c*) it [illegible] beneficial effect by checking the consumption of the individual [illegible] economies and the government gets its revenue—so taxation [illegible] is twice blessed (Withers)

the government should depend mainly upon the funded debt. (ii) The debt should be also in a varied form so as to suit the needs of different classes of investors.

Conversion of Public Debts

The process of conversion consists in converting or altering a loan at one rate of interest into a loan at a lower rate of interest. Several important examples of conversion are to be found in the financial history of England, France, and the United States.

The state carries out the conversion of the debt by offering its creditors the choice of repayment or of new securities at a lower rate of interest.

Advantages

This reduction in the rate of interest by conversion is perfectly fair to the creditor, for the creditors are allowed the option of getting back the principal of the debt.

And the main advantage of conversion to the taxpayers is that *it reduces the burden of interest* to be paid by the state and relieves the tax payers. The finance minister as the guardian of the interests of tax payers should always be on the look out to see whether conversion is possible and when it is possible he should carry it out to relieve the tax payers' burden as far as possible.

Certain general considerations should guide the finance minister in his work of conversion.

(1) Conversion can be successfully carried out when the credit of the Government is good and its stock is above par. Punctual payment of interest on the public debt by the Government, suitable provisions for debt redemption and generally speaking efficient management of the debt improve the credit of the government and make conversion possible. Some other rules laid down by financiers are—

(2) The beginning of a period of prosperity just after a commercial crisis is the best time for a conversion because then the rate of interest is low.

(3) The capital of the debt should not be increased by conversion except in very special cases.

(4) The scheme should be made simple so that it will be readily understood by the people and the conversion will thus be made successful.

The funds set free by conversion can be applied for the remission of taxation or for the redemption of debt Prof Bastable thinks that the latter use is generally the preferable one

Redemption of the debt

Generally speaking the redemption of the public debt is desirable As the state borrows money under great pressure and generally when it finds itself unable to raise funds by the agency of taxation, it is clear that the debt should not be made a permanent one and attempt should be made to redeem the debt at the earliest opportunity

We may consider the subject of redemption under the three following heads—

(1) *Redemption of the floating debt*

This is eminently desirable A large floating debt disturbs the money market and is a source of embarrassment to the government And when redemption is not possible, the greater part of it should be converted into funded debt

(2) *Redemption of debts contracted for productive public works*

Every productive public work (e g a municipal telephone system or a municipal tramway or a municipal water supply apparatus and organization) has a limited life, will last for a number of years and produce an income during these years The redemption of the debt contracted for a productive public work should be carried out within the period during which the public work will produce its revenue otherwise the future generations will be burdened with more than their just shares of the public debt

(3) *Redemption of funded debt including non-productive debt*

Some of the arguments used against the repayment of public debt are the following—

(1) The burden of the debt diminishes with the progress of the society, and the accumulation of national wealth, so the work of redemption will be easy in future and it is not necessary in the present time

Again it has been said that a progressive depreciation in the value of money will decrease the burden of public debt and so the necessity for redemption is not urgent (The answer to this is that

the value of money may not only fall, it may also rise and so it will be unwise to depend upon this resource.)

(2) It is also pointed out that in those cases where taxes are oppressive, ill-devised and weigh heavily upon the industry and trade of the country, a remission of taxation is more desirable than reduction of the debt (This is quite true, but these are exceptional cases In normal cases where taxes are not oppressive etc, redemption is desirable)

The general argument in favour of redemption of debt is this—

Inspite of the arguments advanced against the redemption of debt, redemption is desirable because—

(1) Each period of national history has its own charges to meet and the neglect of repayment in the present may increase dangerously the burden of debt for the future generations

(2) The repayment of debt if properly carried out and if its amount is kept within the bounds set by the extent of suitable taxation will not press heavily upon taxpayers and will not weaken national power

(3) Another advantage is that repayment of debt improves public credit and makes possible lowering the rate of interest on public loans and thus affords means for reducing taxation

[The general proposition that redemption of public debt is desirable does not apply to the following exceptional cases

(1) During a war with its heavy financial burden, the repayment of public debt must obviously be stopped

(2) Again when the burden of taxation is excessively heavy in a country, it is better to remit taxation and to relieve industry and trade than to continue the work of redemption of public debt.]

The Sinking Fund

The sinking fund is a fund accumulated for the redemption of the debt It may be an annual fund (that is a portion of the annual income) or it is the accumulated capital from one or more sources for repayment of the debt When a government is embarrassed for money and has to stop the work of redemption for a time, the sinking fund is suspended

A Capital Levy

It has been proposed to repay the whole (or great part) of the enormous war debts of the last great war by means of a big levy on capital This subject has been widely and exhaustively discussed in Germany and Austria, in Britain, Italy and the United States

Questions

1 Define Public Finance Why is its study so important

2 State and explain the law of increasing public expenditures

3 (a) Give briefly the general principles regulating public expenditures
(b) Classify public expenditures according to (i) objects (ii) the political units involved

4 Enumerate the important sources of public revenues What are fees? Special assessments? Taxes

5. Consider the various principles of attaining justice in taxation (C U 1913) What do you understand by equality of taxation? (C U 1914)

6 What does Walker consider to be the ideal tax, and what is meant by the purely economic theory of taxation? (C U 1900)

7 Give the important canons of taxation

Or

Upon what principles should a Government determine its tax system? (C U 1915)

8 Give the general arguments for and against progressive taxation (C U 1914, 1909H)

How far is progression in taxation possible and how would you justify it? (C U 1913

9 A finance minister has to raise a certain revenue by taxing commodities What are the general principles, which should guide him in selecting commodities for this purpose (C U 1911)

10 Is there any essential distinction between direct and indirect taxes Discuss the arguments for and against each system of taxation (C U 1910)

Distinguish the comparative advantages and disadvantages of direct and indirect taxation as a means of raising revenue (C U 1910 H)

11 (a) What are the useful qualities in customs taxes Discuss the merits and defects of excise taxes
(b) Give briefly the advantages and disadvantages of an income tax, (C U 1918)

12 (a) Explain the terms incidence and impact

Give the incidence of a tax on (i) economic rent (ii) interest (iii) profits (iv) wages (v) monopolies
(b) Consider fully the direct and indirect economic effects of a duty on motor cars in India (C U 1915)

13 For what purposes should the state be allowed to borrow Sketch briefly present theory on the subject

14 Enumerate the different forms of public debts?

What are the considerations which should have weight with a finance minister in determining (a) the issue (b) the conversion (c) the repayment of public debt (C U 1912)

CHAPTER II

Economic Functions of Governments
Socialism etc

The State

The functions of the state with reference to economic activities have been thus classified—the state may (I) *undertake industries itself* (II) *control* economic activities (III) or *encourage* them

(I) State industries

The state may undertake to manage industries of certain kinds (a) *to develop the national industrial life* or (b) *to achieve social, political or economic ends* which would not be realised otherwise

(i) Social monopolies

There are certain kinds of business (for example the supply of gas, water or tramways etc in towns) which are bound to be organized as monopolies, and so these have been called social monopolies *The governmental management of these social monopolies has been advocated*, on the ground that it will prevent the abuse of monopoly power by private business men and will benefit society There are however practical difficulties specially in huge towns like Paris or New York or London where these industries would be on an enormous scale but at least there should be government regulation even in these cases

The postal service in many states is a social monopoly managed by the government of the state

Railways are also social monopolies , but their case is a complicat and controversial one Under certain conditions governmental ownership and management of Railways succeed and under other conditions they are failures

(ii) *Where the purity of the supply is a matter of supreme importance as in the case of the currency*, the state may think it advisable to provide the supply itself and not to depend upon private enterprise

(iii) There are certain *economic services which would never yield a profit to private enterprisers*, but which must be undertaken by the state on account of the *large consumer's surplus* which the community would get from the provision of these services

(iv) There are certain cases in which there would be profit in the long run even for private enterprisers, but the stimulus of private gain at some distant future is not sufficient to induce private enterprisers to bring about the required supply in the present *Railways (or irrigation works) constructed to hasten the economic development of the country*, these would be paying in the long run even for private enterprisers, but as they are not willing to wait for so long they have often to be constructed by the state

(v) The state is the guardian of the interests of unborn generations and so has to take measures for *afforestation, conservation of natural resources*, etc Private enterprises looking to immediate gains are not fitted for looking after these things

(vi) *The development of national industrial life* The state has sometimes to pioneer industries by state help and under state management , and it often manages railways and transport industries not for the sake of mere commercial profit but with a larger outlook so as to bring about the development of national industrial life

(vii) Then there are industries which are owned and managed by the state for *political reasons* e g national defence Industries engaged in the manufacture of munitions will furnish examples

(II) State control of economic activities

State control is required when private business enterprise has vigour but is likely to injure society incidentally Here control is wanted to regulate private enterprise and to prevent the injury State control of private enterprise is wanted in social monopolies (when state management is not practicable) and it is also wanted to prevent adulteration and other injuries to society

(III) State encouragement of industries

Such encouragement is required when private enterprise is not sufficiently vigorous and enterprising and more vigour and enterprise are wanted in the interest of the community The encouragement given by the state takes various forms

(a) The state may encourage directly by *bounties or subsidies*. The bounty may take the form of *guaranteed minimum of profit* and it may take other forms

There may be bounties on production or for export.

(b) The state may encourage native industries indirectly by protecting them from foreign competition,

Railways and the State

In many modern countries, railways are owned and managed by the State In the United States and in England railways are privately owned and managed but under state regulation and control, and a fundamental problem of railway organization in these countries is whether the present system should be continued, or whether it should be replaced by government ownership and management of railways

(a) *Arguments in favour of private ownership and management (and against public ownership and management)* The principal arguments advanced by the advocates of private management are (i the greater efficiency of private management ii) the greater elasticity of private management in meeting the varying demands of business (iii the danger of undue favours to employees under state management specially in democratic countries where railway workers have votes and political influence (iv) the danger that railway rates, and railway expansion etc, would be influenced too much by politics and too little by sound financial and economic considerations

(b) *Arguments in favour of public ownership and public management (and against private ownership and private operation)*

The principal arguments advanced by the supporters of public ownership and management are the following (1) The State would look to the interest of the people as a whole, their industrial development, private management looks only to profit

(2) Elimination of personal discrimination and all other kinds of unfair tactics as regards railway rates etc

(3) At present railways under private management in the United States and elsewhere exercise a corrupt influence on politics, their tortuous management and ominous consequence in the greater inequality of wealth are other serious evils These will disappear under state management

(4) The unearned increment would go to the the State

State versus Company Management in India

In India, at the present moment, there are only two important lines owned and managed by the State *The bulk of the railway mileage* (about two-thirds of the whole) *is State-owned but worked not by the State but by lessee companies* The policy of replacing this company-management by State management is just now receiv-

ing influential support from certain circles but is being stoutly opposed by other classes

The principal argument of advocates of State management in India is that railways under company management care only for profit, while railways under state management will also care for the public interest, and will hasten the industrial development of the country by low freight rates etc.

The supporters of the present system of company management maintain (a) that company lines are on the whole more efficiently, more economically, and more satisfactorily managed than the existing state-worked lines.

(b) that the experience of state-worked lines in India in the past shows that company management is better suited to the needs and circumstances of India and is better calculated to increase the material prosperity of the country (c) and that from the political point of view, an extensive enlargement of the existing bureaucracy is undesirable

The State and Trade

The question as to the proper relation of the state to trade, what are the advantages of abolishing restrictions on trade, and under what conditions, and also the cases in which restrictions on trade become necessary and desirable—these are discussed in the chapter on International Trade

The State and Labour

For the relation of the state to labour, and the necessity of imposing restrictions on labour in the interest of the labourers themselves, and also in the economic, political and social interests of the community as a whole—see Labour Legislation, and Factory Laws Book v ch iv

The State and the Poor

See Poverty and Poor Law Book v ch iv

The State and the War—See the Appendix on the war

During the War and for carrying it to a successful conclusion, agriculture, manufacturing industries, railways and other forms of transport have been extensively controlled and regulated by the state—and this has strengthened the demand for nationalisation of land, mines, railways etc among the labouring classes of Europe and America

SOCIALISM. ECONOMIC PROGRESS

The present distribution of wealth

I Arguments against the present distribution of wealth (see Part II pages 146, 147)

II Arguments advanced in justification of the present system of distribution of wealth

(A) Economists of the Classical School

The economists of the classical school, and of the optimist school regard *the present distribution of wealth as perfectly just* They argue thus, under the present system, society is based on the liberty of labour and the absolute freedom of contract and *every one receives the just and exact equivalent of the wealth he creates by the law of supply and demand* Society by the law of supply and demand determines the prices of agricultural products, manufactured products, etc, also the shares in distribution (viz wages, interest, rent and profits) which are the prices of the service of labour, capital, land and organization The public is the best judge, and the public judges and pays

These writers also point out that *competition tends to correct any inequalities* and *injustice that may arise* If a particular product or service is sold for a time at an excessively high price, numerous rivals immediately throw themselves into the same industry or career, and thus bring down the value of the product or the service to the level of the cost of production

[Other arguments advanced in favour of the present system of distribution are (1) *it stimulates productive activity* by allowing each individual to act freely in his own interest, and to keep to himself the fruits of his labour

(2) Moreover the present system possesses an advantage over all other imaginable distributive systems in this – the *present system works automatically* by the law of supply and demand and it does not require any distributive authority which is wanted under other systems Again the *present system secures liberty* which other systems would sacrifice in endeavouring to secure a large measure of justice in distribution]

(B) Prof Smart's view

Prof Smart takes a more moderate position as regards the justice of the present system of distribution, and in this he represents recent economic thought on the subject:

A kind of rough justice in the present distribution, as it measures payment roughly by service

Smart admits that perfect justice has not been attained, but he points out that something curiously like *a rough justice* has emerged "At least it is not a distribution to idlers, nor a distribution by force or fraud nor a distribution due to the favour of the distributers, to patronage or to privilege It is in some sense, a distribution according to product, and is based on mutual service" The rough justice of present distribution is established by pointing out how far arbitrary division is eliminated At least payments are not arbitrary where there is mobility (a) The payment of *labourers* is prevented from being arbitrary by the mobility, and the solidarity of labour (b) As regards *employers*, competition between them prevents the arbitrariness of profits (c) As regards capital, capital also is prevented from getting an arbitrary remuneration by its mobility When the supply of capital increases rapidly, the rate of interest falls, and there is difficulty in getting employment for capital

Prof Smart rightly makes a modification in this claim of rough justice—*it is such justice as we can have under a system of private property and free transfer of property* [In considering the argument against private property, he points out that (i) rent under modern conditions (with continual sale and resale of land as an investment, and the development of communications is not a strong argument against private property, (ii) and interest is also not a strong argument because the man using borrowed capital and paying the present rates of interest gets a great deal of work out of the capital]

And his conclusion is this "*At least there is enough of rough justice in it to make even those of us who feel its imperfections most keenly think twice before we give our countenance to any rival scheme which has yet been proposed*"

Of such rival schemes, socialism with its many varieties is at present the most influential and important

† Socialism

The existing system of distribution of wealth and also its pro-

† "What is socialism? It is almost like asking "What is Christianity?" Or demanding to be shown the atmosphere It is not to be answered fully by a formula or an epigram Socialism then, is a great intellectual process, a development of desires and ideas that takes the form of a project a project for the reshaping of human society upon new and better lines That in the ampler proposition is what socialism claims to be" *New Worlds for Old—H G Wells*

duction are closely dependent upon the legal structure of society specially upon the laws of private property and competition Socialists regard the present system of distribution of wealth as extremely unjust And the *search for a better system of distribution has given rise to numerous systems of Socialism* Thorough-going modern Socialists propose not only vast and far-reaching changes in distribution but also corresponding changes in production and exchange and these changes necessitate fundamental changes as regards the laws of property

Socialism is not always violent and lawless—there are socialists violent and lawless, who are for anarchy and dynamite, but there are many socialists who are opposed to all violence and advocate peaceful methods and progressive evolution Again *socialism is not essentiall anti-christian or anti-religion*—though Marxian and other continental socialists generally reject Christianity, there have been many socialists among the leaders of the Christian Church in recent times, Maurice, Kingsley, Dr Clifford in England and others elsewhere Nor do all socialists aim at abolishing the family or encouraging free love

‡ There are many kinds of socialists and there are many kinds of socialism Moreover Socialism is still in process of development and change——it is not a stereotyped system of dogma, it is living, it changes and developes and it will change and develope with the intellectual and moral development of modern societies

The word Socialism appears to have been first used in *The Poor Man's Guardian* in 1833 Among modern socialists the important names are (*1*) in France—Saint Simon, the historic founder of French socialism, Fourier, Louis Blanc and Proudhon (2 in Germany—Ferdinand Lassalle, Rodbertus and Karl Marx, undoubtedly the greatest figure in modern socialism (3) in England—Robert Owen, Maurice, Kingsley, and in recent times William Morris, Sidney Webb and others

History of Socialism

(1) The utopian socialism in the early nineteenth century

Earlier French and English socialism down to 1848 was largely *utopian and idealistic* (It was also dominated by a *bourgeois or middle class spirit* and *was not of and for the working class*)

‡ History of Socialism—Kirkup

These early socialists impressed with the evils of the competitive system and private business enterprise proposed socialistic schemes which were expected to remove these evils These socialists are called utopians and their socialism utopian socialism because *they reasoned from ideal postulates and they advocated the regeneration of mankind through education and brotherly love in ideal communities* Unlike many modern socialists they did not want a revolution to establish a socialist state but they appealed to the dominant classes for aid to carry out their social programme

The most important of the earliest socialists were Robert Owen, Saint Simon, Fourier, Cabet and Blanc (Short accounts of their socialistic schemes are given at the end of the chapter) Blanc was however less utopian than the others He was transitional and he marked the transition from utopian and bourgeois socialism to the later 'scientific' and proletarian socialism

(2) The proletarian and 'scientific' socialism of the latter half of the 19th century

We now pass to the *proletarian socialism* of the second half of the nineteenth century, a socialism of and for the working class And this socialism calls itself a *scientific socialism*, it prides itself upon its scientific realism and ridicules the utopian ideals of the earlier socialists

The 'scientific' socialists fall into two important groups

(a) State socialism

The advocates of state socialism who are nationalists and who propose that the socialistic programme is to be accepted by the state and to be carried out by the national government

The leaders of this school are Rodbertus and Lassalle The influence exercised by Rodbertus on economic thought has been very considerable

Rodbertus's economic thought proceeds from two main ideas

(1) A labour theory of productivity—labour produces all economic goods (2) A belief in a decreasing wages share The second idea is connected with his theory of the iron law of wages

Rodbertus's great service to economic science is to have brought out in a forceful manner the question of distributive justice

Rodbertus is not for revolutionary methods or for agitation. His position was 'social, monarchical and national'

(b) International socialism of Karl Marx

Like Ferdinand Lassalle, Karl Marx was a Jew, and a German Jew by origin The Jews have produced many great names in philosophy, letters, art, music and science, but few greater than that of Marx With Marx socialism took on a purely materialistic garb and became international in scope as contrasted with the national industrialism or state socialism of Rodbertus

The international socialism of Marx is revolutionary in temper and it is abstract and deductive The principal features of scientific socialism as taught by Marx are the following

(1) Society is an evolutionary product.

(2) *History is to be given an economic interpretation* i e the history of our whole social life including religion, government, art etc is to be regarded as only a reflex and a result of past and present economic conditions

(3) † *Marx's theory of value and his doctrine of surplus value*

Marx thinks that labour produces all value, capital being nothing but stolen labour The whole value of a commodity depends upon the quantity of labour expended upon it In its quantitative aspect, value is reduced to socially necessary labour time—to the time spent by the average labourer in producing the commodity under existing social conditions

The doctrine of surplus value is that the labourer produces more than he gets as wages, and the surplus value which is produced by him is appropriated by the capitalist, the employer and the landlord in the shape of interest, profit and rent The labourer is thus deprived unjustly of a large part of the value produced by his labour

(4) *The doctrine of the class struggle*

The exploitation of the labouring class by the capitalist and the

† Marx distinguishes between use value and exchange value
"The utility of a thing makes it a use value "

As regards exchange value Marx remarks "We see then that that which determines *the magnitude of the value of an article is the amount of labour socially necessary or the labour time socially necessary for its production* The value of one commodity is to the value of any other, as the labour time necessary for the production of the one is to that necessary for the production of the other As values, all commodities are only definite masses of congealed labour time "

Karl Marx—Capital

landlord classes produces a profound antagonism between these classes, and this antagonism has given rise to a class struggle which can end only in the overthrow of the capitalist and landlord classes and the triumph of the labouring class and the establishment of the socialist state

Marx is unquestionably the most powerful personality in the history of socialism and his *Capital* (*Das Kapital*) has been called the Bible of socialism This work of Marx is a study and a criticism of capital, but indirectly it is a brilliant exposition of socialism armed with all the learning of the nineteenth century

Criticism of Marx's Theory

Marx, brilliant and suggestive as he is, is open to serious criticism on many points

(1) History should not be given a purely economic interpretation Too many things occur for reasons not entirely economic or even not economic at all

(2) The Marxian theory of value is also unsound and his theory of value is the heart of his whole system The Marxian theory of value is unsound (a) because it neglects the factor of utility and and does not deal with utility at all adequately (b) because even assuming that cost alone can explain exchange value, it is not true that all cost can be reduced to labour (Value is thus due not to labour cost alone) (c) The Marxian theory of value also breaks down before insuperable differences in the quality of labour The doctrine of surplus value is thus not founded on facts

(3) The doctrine of class struggle also is not completely borne out by facts The struggle between the classes is not growing more and more acute every where, and even many socialists to-day are of opinion that the victory for socialism would be won without blood-shed and not by bloody revolution as Marx expected

The revolutionary and the evolutionary socialists

Marx, Engels and their orthodox followers were revolutionary socialists, who expected that the socialist state would be established by a revolution A very large body of socialists at the present day have a socialism which is not revolutionary but evolutionary And these evolutionary socialists believe that the socialist state would be established without bloodshed and revolution and as a result of a

gradual increase in the strength of the socialist party as a political organization in most modern states. The majority of intelligent socialists of the present day are evolutionary socialists.

The tendency among modern socialists, is to reject certain parts of Marx's theory and to maintain the rest, to reject the materialistic interpretation of history and the theory of surplus value, while accepting the doctrine of the class struggle, internationalism and the socialisation of the instruments of production. Some leading figures among recent socialists are Bernstein in Germany, Jaures in France, Sidney Webb in England. The evolutionary socialists are also called revisionists or opportunists.

† Characteristics of modern Socialism

Modern state socialists would expand the business functions of the state, so that all industries would become state industry managed by the state. *Private economic activity is to be ended and to be replaced by public economic activity.* And all such business would be regulated by the people in their organized capacity. The present political organization is to become an industrial organization based upon the will of the people and their suffrage. In this way, *there will be industrial democracy as well as political democracy.*

The socialists propose

(1) State ownership of the instruments of production viz. Land and Capital.

(2) State management of the instruments of production, and production of wealth under state control and management.

(3) The distribution of the product of industry (*i.e.* the national income) among the different classes by the authority of the state.

They do most seriously object to the ownership of capital or of land by private persons because private ownership of the means of production leads to the exploitation of the labouring classes.

Though the socialists object to the private ownership of instruments of production, all of them are not opposed to the existence of private property in income earned by individuals under the socialist state.

† Not all socialists are for basing Socialism upon the state as we know it. The early utopian socialists depended upon private effort and experiment, and on the other hand, Marx was for a vast international combination of the labourers of all nations without distinction of creed, colour and nationality—but modern state socialists would make the state itself socialistic, and would base socialism upon the state as it is.

Socialistic criticism of the Modern State

Socialists of different schools criticise the existing system of production and distribution of wealth as carried on under the Modern State They put forward economic as well as moral and social objections against the present industrial system

1 Economic objections against the present system

(and economic advantages claimed for socialism) (1) Production under the present system is inefficient because of the wastes of competition and the haphazard methods of present industry

Socialists declare that in their system production will be scientifically organized and would be much more efficient They claim that (a) the economic needs of the community will be accurately estimated and the available land, labour and capital carefully apportioned so that just the quantity of each kind of goods required will be produced (b) The duplication of plants and staffs and the excessive production of particular goods, now so common under competition, will be avoided

To quote Prof Ely "Competition is wasteful Two railways are built where one would suffice look at the shops, wholesale and retail, and see the waste of human force Without competition the whole dry goods and grocery business could be carried on with a third of the present economic expenditure of force"

(c) Socialism would save the enormous *expenses of advertising and competitive selling* incidental to the present system

(d) In the modern state there are the *idle classes* who spend but do not work Socialism would make them work for their bread

(e) *Unemployment* which becomes widespread with the coming of crises and depressions is one of the serious evils of the modern industrial organization Socialists claim that they will abolish unemployment by a more scientific organization of production

(2) The present *distribution of wealth* concentrates wealth in the hands of a few rich landlords, capitalists and business men, while the vast majority of workers get less than their proper share of wealth and are poor Socialists declare that they would establish a just distribution

(3) *Then as regards consumption*

To-day goods are made by producers for sale, they would be made for use, for the benefit of the consumer in the socialist state Socialism would suspend the production of harmful goods and would abolish adulteration and deception

II Moral objections against the present system
(and moral advantages claimed for socialism)

The injustice of the present system of distribution is a grave moral objection The fundamental objection is that modern industry is based upon self-interest. Socialism is based on worthier motives. Under it all men would live like brothers "Socialism relies upon the love of activity for its own sake, the desire to contribute to the common good and the ambition to win social esteem and social distinction through conspicuous social service"

† The strength of Socialism

The Socialistic criticism of the modern state and the constructive programme of the Socialists make quite clear the elements of strength in socialism The strength of socialism lies chiefly in the plea (1) for a scientific organization of the productive forces of society, and the socialistic criticism of present waste and also of the idle rich who do no work (2) for a just distribution of the annual social income Other elements of strength are socialistic criticisms (3) of the present regime in the matter of unemployment (4) of adulteration, deception and cheap and nasty goods which are the outcome of the system of private capitalism in which goods are made to sell and not for use (5) and finally of the selfish spirit of competition

The Weakness of Socialism (*The arguments against Socialism*)

The weakness of Socialism lies (A) partly in the weakness of some of the arguments employed by the Socialists against the modern state (B) partly in the defects attaching to the constructive programme of the Socialists themselves for the establishment of the Socialist State

(A) The following among other things are elements of weakness in Socialism

(1) The predictions of Marx and his followers about the modern state have been falsified so far, and the evils of the present system may be removed in future without the establishment of socialism

† For a vigorous and popular exposition of the case for modern socialism, the student is referred to *New Worlds for Old—H G Wells*

(2) The Marxian doctrine of the class struggle, and the economic interpretation of history as given by the socialists are partly erroneous

(3) The socialists underestimate the efficiency of the present system "To-day there is a premium on energy and thrift Much may be wasted, but much also is produced" †

The socialist sees all of the starvation, misery, luxury and extravagance in connexion with the present system, but he ignores the millions of happy homes scattered throughout the land in rich and progressive countries like Britain, France and the United States

(4) The socialist underestimates the importance of free enterprise to be found in modern industry

(B) *Defects in the constructive programme of Socialism about the establishment of the Socialist State*

(1) In the Socialist State, the difficulties of administration would be enormous There would be serious difficulties relating to the apportionment of labour among the various industries, specially as regards unpopular occupations, about the assignment of value to products, about the quantity of goods to be produced, the relative proportion of capital goods and consumers' goods etc

A great difficulty would arise in connection with the distribution of the national income On this question socialists differ among themselves Some advocate equal distribution, others advocate distribution according to needs, while the more reasonable are for distribution according to efficiency

(2) It is feared that *industrial progress would be hampered* under the socialist state, and production will be less efficient than under the present regime

In the absence of the incentive of competition and the stimulus of private ownership and private enterprise, the *accumulation of of capital, and also inventions and improvements would be checked*

(3) *Political and social dangers of Socialism*

Then there is the danger to liberty and also other evils of a political and social character under socialism Everything (the choice of occupations, methods of production etc) would be

† Ely—Outlines of Economics

completely regulated by the gigantic bureaucratic machine, and possibly there would be an end of individual liberty, initiative and enterprise The loss to society and civilisation under these circumstances would be incalculable

And under present conditions of public morality, there would be an immense amount of political corruption, intrigue, personal spite and favouritism on the part of the rulers of the State (however they may be elected or appointed)

(4) The socialists make the fundamental mistake of underrating the *psychological obstacles* to their plan The average man is neither so inclined to work nor so zealous for the common welfare as socialism demands And when men are as perfect morally as would be required of them under socialism, socialism would become unnecessary

[Economists differ among themselves as to the difficulties of socialism and its practicability, and they differ in the emphasis which they lay upon the various objections against socialism Prof Taussig, (with many others) thinks that in the Socialist state organization, the valuation of commodities, and the accumulation of capital would *not* present serious obstacles and that for the mass of men, there would be practically little diminution of real liberty He seems to be of opinion that the real difficulties will be largely of a psychological character and that the maintenance of vigour, efficiency and progress would be practically impossible both as regards the rank and file of the workers and also as regards the leaders and also the increase of effective capital through improvement and invention]

Influence of the socialists

Prof Haney in his "History of Economic Thought" thus sums up the influence of the socialists

1. Direct or Primary effects

(*a*) The scientific socialists and particularly Karl Marx strengthen the idea that social institutions are of historical growth and relative to environment

(*b*) The socialists give greater strength to the tendency to take the social view point as distinguished from the individual view point They emphasize the fact that under modern production the product is a social one

(*c*) Socialistic criticism has led to a closer examination of the economic functions of the state

(*d*) Socialism has emphasized the problems of distribution as contrasted with production and above all has kept the question of justice in distribution, heavy upon our consciences

(*e*) Socialism as a whole has brought the general idea of unearned increment into prominence

(*f*) The function of capital and the nature of profits have been placed in a clearer light on account of socialistic attacks

The downfall of the wages fund doctrine may have been furthered by socialistic criticism

(2) Secondary or re-actionary effects

(*a*) Socialism has deeply influenced the tone and temper of economic writings Examples of this are to be found in (i) the work of the Austrian School (ii) the work of Clark

(*b*) Certain particular theories, (for example, the productivity theory of distribution) have received their emphasis from a desire to refute socialism, and the marginal utility theories have been probably developed by reaction from the labour cost theories of the socialists

Socialism in present politics—*Influence of Socialism on legislation and administration in modern States*

Up to the present time, except in a few small and scattered communities, no attempts to apply the principles of socialism to their full extent have been made No large modern state has adopted the complete programme of socialism —*Socialism is thus an ideal rather than an actuality* (The only exception is Russia which is in the grip of *Bolshevikism*—an extreme and violent form of socialism about which little accurate information is available to the civilised world up to the present moment)

The socialist ideal however counts its adherents by millions in the modern civilised world, and it is exercising in an increasing degree great influence on the legislation and administration of modern states Socialists have great political influence in many continental countries (Germany, France, Italy, etc) and they have become of considerable importance in England and the United States Numerous reforms in social legislation have been either the direct work of socialism in politics or the indirect results of its influence Workingmen's insurance, factory laws, industrial courts, tax reforms, the movement for a universal suffrage—all these things aiming at the improvement of the economic and the political condition of

the masses have been influenced by the efforts of socialists In the progressive countries of Europe and also in the United States, socialists have put into practice some of their administrative theories —and their activities include increased care for the poor, specially for children, extension of education, improved sanitation, popular concerts and theatres, together with the municipal control and management of waterworks, gasworks, street railways and other public utilities

† Prof Gide on the Socialistic systems of Distribution

Socialists, dissatisfied with the present system of distribu ofnebu looking upon it as unjust, have proposed other systems for t sotgh distribution of wealth A summary of Prof Gide's accountti *socialistic schemes* is given below As Prof Gide points o socialistic systems are respectively based upon the followin formulas of distribution viz

(I) To each an equal share
(II) To each according to his needs
(III) To each according to his deserts
(IV) To each according to his labour.

1 Equal sharing

Distribution into equal shares

This simple mode of distribution seems to have prevailed in a far off past among primitive communities In modern societies it would be absurd; *and to-day even among revolutionary socialists there are no longer any advocates of equal sharing* Something of the simplicity of this idea still seems to lie at the basis of socialistic systems which assume that there is more than enough wealth for the wants of all Poverty prevails because the rich have unjustly taken too large a share of the national wealth, and so wealth should be taken from the rich and given to the poor

Objections

Equal sharing will not be of much use The rich constitute a small minority, and if the wealth of the rich is distributed among the poor, that would not improve much the economic condition of the masses

II Communism

Distribution according to wants

Let us regard all wealth as belonging to everybody Let every one consume according to his wants This is the essence of communism Communism is, according to Prof Gide, the simplest and the most ancient of all socialist systems, and it has been received by the Anarchist school The most recent and best known advocates of communism are Baboeuf,

† Gide—Political Economy

Robert Owen and Cabet In the programme drawn up by the Social Democrats of Germany (Gotha, 1875), it was provided that all shall enjoy the results of labour according to their reasonable wants

Objections

Two important objections to communism are (i) that the quantity of wealth is, and probably always will be insufficient for our wants or desires (ii) communism will require some sort of regulating authority and this will not exist under Anarchism And the justice of communism has been questioned Prof Schmoller says rightly "It is a mistake to make our needs a rule of distributive justice, for our needs have necessarily an egoistic character; it is labour, merit, acts which alone can serve the human race and furnish a rule of distributive justice"

Actual experiments in the United States and elsewhere have, however, shown that communism can achieve a partial success in small communities subjected to a very strict discipline

III Saint Simonism and inheritance

The School of Saint Simon exercised for a time an extraordinary influence over a whole generation in France and outside it The writers of this school maintain that *the share of each individual in distribution should be determined by his merit*, they insist strongly on the claims of merit All forms of human activity are to be regarded as public functions appointed and remunerated by the state Saint-Simonism, being based on merit and giving important appointments to large employers, bankers, etc, is an aristocratic and capitalist socialism An essential part of Saint-Simonism is the abolition of inheritance

Objections

(i) Even admitting that we might succeed in abolishing the inheritance of wealth, inheritance would still exist with regard to many other advantages like health, family talent, and social rank

(ii) If men are deprived of the right to dispose of their wealth, then we shall lose a very powerful stimulus to production

(iii) If the Saint-Simonians are right in holding that the possession of wealth is in itself a social function, is it not logical to conclude that the man who performs this function is the one best fitted to point out his successor?

IV Collectivism

Collectivism is a milder form of communism, and it is of fairly recent date The Manifesto of the Communist party issued by *Marx* and *Engels* in 1847 first brought collectivism into prominence, and its principal armoury of weapons is Marx's famous book Capital *Collectivism proposes the common ownership of instruments of production only* (land, mines, factories, railways, raw materials); consumption goods are still to be left under the system of private property, only a better distribution of them is desired

Expropriation with or without compensation is the only means of accomplishing this transfer of private property to collective ownership Under the collective ownership of the instruments of production, wealth would be collectively produced, and would be distributed by the state *And collectivism proposes to reward each individual according to the effort he has made*, measured by the number of hours he has worked The collectivists believe in a supposed law of social evolution which maintains that individual production is being gradually transformed into collective production

Advantages Prof Gide enumerates the following advantages claimed on behalf of collectivism

(i) Under this system, no one is able to get anything except by his own labour In this way *economic inequalities will be greatly reduced*

(ii) *Idle classes and social parasites will disappear* because private ownership of land and capital will not be allowed

(iii) *Collectivism will abolish pauperism* Society under collectivism would find work for all who are able to work, and for those unable to work, society would provide the means of subsistence

(iv) The hours of labour for the average labourer will be greatly reduced (An English socialist calculated that one hour and twenty minutes per day would be enough but this seems to be an exaggeration)

(v) By recognising the right to dispose freely of one's possessions, individual liberty would be maintained

Objections

Prof Gide mentions the following objections usually put forward against collectivism

(i) The so called historical law of social evolution (viz the gradual transformation of individual production) is a sweeping generalisation and is not supported by facts

(ii) The right of private property restricted as it would be by the collectivists would be a mere delusion

(iii) The plan of getting rid of the captains of industry and replacing them by paid managers will enormously lower industrial efficiency, production will suffer very seriously

(iv) Under collectivism, the motive of individual saving will be destroyed, because private ownership of capital will not be allowed And public saving will not prove a satisfactory substitute

(v) The liberty of the labourer will be suppressed The labourer will have no choice about his occupation or his employer ; he will have to accept any post which will be given him by the rulers of the state.

(vi) The formula of collectivist distribution "to each man according to the number of hours of labour he has furnished" will lead to great

practical difficulties, and will raise an important ethical problem The ethical problem is whether it is just to pay the labourer according to the hours he worked or according to his product

Co-operation

Co-operation aims at a complete programme of social reconstruction Though directly descended from the Associationist socialism of the first half of the 19th century, *it is not strictly socialistic* because it would retain private property with its principal attributes *Yet it seeks to realise some of the most important objects of socialism*, and it is doing an immense amount of good to persons practising it

For different kinds of Co-operation see Part I pages 212-214.

Prof Gide mentions the following as important characteristic features of all kinds of co-operation

(i) All co-operative associations aim at *the economic emancipation of certain classes* of persons that they may dispense with middlemen and be self-sufficient

(ii) *All aim at substituting solidarity for competition*, and the co-operative motto "Each for all" in place of the individualist motto "Each for himself"

(iii) All aim, *not at abolishing private property, but at spreading it* by making it accessible to every one in the form of small shares and hey also aim at the creation of collective property

(iv) All aim at depriving capital of its controlling share in production, and abolishing profit, and not doing away with capital itself

(v) All co-operative associations possess a considerable *educational value* They teach their members, not to sacrifice any part of their individuality or their spirit of enterprsse but to develop their energies by helping others while helping themselves to abolish all the methods by which men exploit their fellow men and all causes of conflict

Right of Private Property

While discussing socialism and other schemes of social reform, the right of private property comes in for criticism and examination

(1) *Theory of Natural Right.*

The upholders of this theory maintain that property is a natural right But if property is a natural right, what are we to say to those persons who have no property and demand it? The aim of social science must be to see that each man has a minimum of property

(2) *Labour Theory*

An attempt has been made by the classical economists and other persons to prove that *labour* is the basis of property A man should own all things he has created by his labour *Objections* The theory is

not applicable to actual conditions because (i) portions (and often considerable portions) of a man's property are due to inheritance and other causes and not due to his labour (ii) the labourer is not the owner of the product he produces by labour,—the product belongs to the employer

In reality, the right of private property like all other social rights must be examined from the standpoint of social welfare, and must be limited and regulated from that standpoint

Standards of life and standards of comfort Progress in relation to Standards of life

What is the connection between changes in the manner of living and the rate of earnings? How far is either to be regarded as the cause of the other and how far the effect? This is a question of the greatest importance in our present generation

In this connection, Marshall takes the *standard of life* to mean *the standard of activities adjusted to wants* "*A rise in the standard of life* implies an increase of intelligence and energy and self-respect, leading to more care and judgment in expenditure, A rise in the standard of life for the whole population will much increase the national dividend, and the share of it which accrues to each grade and to each trade A rise in the standard of life for any one trade or grade will raise their efficiency and therefore their own real wages it will increase the national dividend a little"

To Marshall *the standard of comfort* is a term that may suggest *a mere increase of artificial wants, among which perhaps the grosser wants may predominate* A rise in the standard of comfort will probably involve some rise in the standard of life, and in so far, as this is the case, it tends to increase the national dividend, to raise wages and to improve the condition of the people A mere increase of artificial wants which does not increase activities and which does not raise the standard of life in any way only makes people more miserable than before, *an increase of wants which does not raise the standard of life cannot raise wages*, except by diminishing the supply of labour

For Progress in relation to standards of life see Marshall, Chapter XIII

(There are some writers however who use *standard of life* and *standard of comfort* as synonymous expressions)

Production

The progress made in production is so familiar as to require only the briefest consideration Man's power over nature has enormously increased and this has immensely increased the efficiency of production Invention and discovery have scored triumph after triumph Other causes contributing to progress in production have been the opening up to exploitation of new lands, new sources of mineral wealth, the growth of capital, improvement in forms of industrial organization, and the development of a more capable generation of men and women with better education and wider opportunities than before

Distribution

Then we have to consider the progress in distribution This has not been so remarkable as the progress in production The condition of the wage earners is worse than it should be with the great advance in production

Still statistics indicate that *wages* have risen substantially Trade unions, labour legislation, co operation have acted powerfully in the direction of improving the lot of the working classes Agricultural *rents* have fallen in old countries like England while they have risen in new countries The income of certain enterpreneurs from their monopoly powers absorbs a large part of the social income , and something should be done to diffuse these monopoly incomes either by more general competition or by legal regulation of prices

Exchange

Improvements in means of transport by land and sea have brought about a great increase in trade within the same country and also in exchange between nations The commutation in money of payments in kind and payments in services has been a factor of great importance in the development of exchange

Progress in the future

Economic progress in the past indicates to some extent the conditions upon which the economic progress of the future must depend Changes in habits of consumption which will increase the satisfaction derived by men from goods and lessen the cost of production must continue to be made , methods of production must be further perfected by improvement in the capital goods used, by

fuller utilisation of the forces of nature, by an increase in the fund of capital, by better organization of industry, and by steady improvement in the efficiency of the working population, the distribution of the social income must be so changed as to give a larger share of the product of industry to the working class

Labour unions and labour laws must continue to help the working classes in the struggle for improving their economic condition Monopoly should be regulated in the interest of social welfare and to enforce fair competition There should be tax reform Public revenues must be drawn in an increasing measure from the incomes of those who can best afford to contribute to the common fund for the common welfare These are all reforms for the present and the immediate future and unlike socialism can be immediately brought into operation And economic progress as progress of all kinds ultimately depends upon the individual, upon the character and capacity of the average citizen and unless he responds to the efforts made for his betterment, there is no prospect of permanent progress

The greatest war in history is over The world is just now passing through an extraordinarily acute industrial and social crisis Throughout Europe and America, the masses have awakened to a new sense of their rights and their power——Bolshevikism rampant in Russia, in Hungary and threatening to engulf all civilisation, Syndicalism which has raised its head high in France, Italy, in the United States, in conservative England, the powerful Triple Alliance of English miners, railwaymen and transport workers, the Big Union Movement, even peaceable and constitutional labour movements which no longer seek only higher wages, better conditions of work but also some sort of control, they all in different degrees testify to this growing consciousness of rights and power For socialism with its complete programme, the world is not yet ripe, but mere palliatives, makeshifts and patch-work arrangements will no longer avail, the State at present is largely capitalist in substance and spirit ———a New State must be created, for thinkers, workers, all and broad based on the free energies, strong will and character of a generous, large-visioned people The signs are that, once again, England will lead, others will follow England, the nursery of political liberty, the pioneer of the Industrial Revolution, England the victorious champion in this last great war for justice and freedom——a task not less noble still awaits her For Peace hath her victories no less renowned than War

Questions

1 Consider generally the proper sphere of state action in relation to a country's industrial life (C U 1913)

2. Comment on the following

Two of the most important discoveries made during the 19th century are (*a*) The immense advantages of abolishing restrictions on trade (*b*) The absolute necessity of imposing restrictions on labour. (1912 H)

3. State the arguments for and against the state working of railways (1915 H)

4 Discuss the arguments which are commonly advanced (*a*) in justification of (*b*) in condemnation of the present system of distribution of wealth (C U 1909)

5 Distinguish between the different economic aims that have been included under the name of socialism

6 Indicate the general drift of the criticism of the present industrial system by socialist writers, and discuss the probable advantages and disadvantages of any one of the schemes advocated by contemporary socialism (C U 1910 H)

7 Briefly indicate the general arguments against socialism (1909 H, 1910 H)

Questions

From Calcutta University B A Examination Papers (1909-1918)

BOOK I

1 "When we grant to any branch of human knowledge the name of science, our object is not the simple bestowal of an honorary title We mean the facts with which it deals are connected by certain necessary relations which have been discovered and which are called Laws" State whether you consider that Economics can be called a science according to the above definition and give reasons for your answer (C U 1914)

2 What is meant by an Economic Law? Are we justified in saying that Economic Laws are analogous to the Laws of Nature? (C U. 1910)

3 Discuss the position of Economics among the Social Sciences (C. U 1910)

What is the subject matter of economics? Explain in what way it is a social science, and bring out in your answer its relation to other social sciences (C U. 1917)

4 (a) Discuss the relative advantages and drawbacks of (1) the Deductive Method (2) the Inductive Method What do you consider to be the proper method of investigation in the Social Sciences? (C U 1911)

(b) What are the pre-requisites for the free circulation of labour and capital in a country? (C U 1910)

5 (a) State concisely and examine critically the doctrines of the Liberal School of Economists (C U 1909)

(b) What is meant by the "Economic Harmonies" and how is the doctrine affected by the principle of the degradation of labour (C U (1909)

6 Describe the main features of present day economic societies (C U 1913)

7 Trace the successive stages of industrial evolution (C U 1909)

8 Critically attempt a full definition of wealth How would you estimate a nation's wealth? (C U 1913)

9 Define Wealth, National Wealth, Capital, and in the light of your definitions examine the character of the following (1) natural facilities of transport such as (1) navigable rivers (2) natural intelligence or honesty of the labourer (3) trained skill of an artisan (4) services of domestics, doctor, musicians (5) patents copyrights (6) good-will or business connections (C U 1909)

"Rivers and climates do not constitute wealth" "For many purposes, we ought to reckon the Thames as a part of England's wealth" Discuss these propositions in the light they throw upon each other (C U 1909 H)

BOOK II

Consumption

10 Define total utility, marginal utility (C U 1909 H)

11 State the Law of Demand Upon what experience is it based? Show how demand may be represented diagrammatically (C U 1914)

12 Explain elasticity of demand and show how it may be measured (C U 1914)

Explain the meaning of "Elasticity of Demand" and show its importance in theoretical and practical problems An increase occurs in the supply of rice, gold, tea, toys and scientific books while the conditions of demand remain unchanged What will be the general effects upon the price of the respective articles? (C U 1915)

What is the meaning of Elasticity of Demand? Of what articles would you expect the demand to be inelastic? Give illustrations (C U 1916)

13 Distinguish between necessaries for existence, necessaries for efficiency and conventional necessaries (C U 1909 H)

What is a luxury? Under what circumstances is luxury justified? (C U 1917)

14 Write a critical note on Consumer's Surplus (C U 1913, 1914)

Discuss the relation of Production and Consumption, bringing out clearly how the ultimate control of production lies in the hands of the consumers (C U 1917)

BOOK III

Production

15 What do you understand in political economy by production? What are the factors of production, and in what manner do they co-operate?

16 Carefully state the Law of Diminishing Returns with all necessary limitations In a new country, are the richest lands always cultivated first? Show the weakness of Carey's position and correct according to Marshall the inaccurate but substantially true statements of Ricardo (C U 1909 H)

17 Elucidate the Law of Diminishing Returns and its relation to the doctrine of Rent (C U 1911)

18 Elucidate the statement "While the part which Nature plays in production conforms to the Law of Diminishing Return, the part which man plays conforms to the Law of Increasing Return"

19 Write a note on Malthus's doctrine of population (C U)

Explain and examine the Malthusian doctrine of population (C U 1912)

20 What is the bearing of the Law of Diminishing Return on the theory of population? Illustrate from Indian conditions (C U 1916)

21 What are the influences which affect the accumulation of wealth in a country? (C U 1912, 1916)

Discuss the effect of the rate of interest on the growth of capital in a country (C U 1918)

22 Account for the rise and explain the functions of the entrepreneur class in the modern business world (C U 1909)

Give an account of the functions of the modern employer and the services rendered by skilful business management (C U 1912)

What is the nature of the services performed by the Entrepreneur or Businessman and in what manner is he rewarded? (C U 1916)

23 Examine the industrial effects of the growth of machinery explaining how it has affected the social and economic condition of the working classes (C U 1911)

24 What are the circumstances which favour the localisation of industries and what are the advantages resulting therefrom ? (C U 1912)

What are the factors leading to localisation of industry ? What are the advantages of such localisation ? In what industries is localisation impossible and why ? (C U 1913)

25 What do you understand by large scale production (C U 1911 H) ? What are the advantages of large scale production ?

What are the limitations to the increase of scale in the case of agriculture and other industries ? (C U 1916)

26 Under what general conditions will a Handicraft Industry give place to a Factory System ? Compare the relative advantages of the two systems (C U 1915)

27 Carefully state the Law of Increasing Return (C U 1911 H)

Market, Value, Theories of value etc

28 (a) Define the market of economic theory (C U 1910 H 1912 1915)

What do you understand by a market in economics ? What are the limitations with regard to time and space to which markets are subject ? (C U 1918)

Upon what conditions does the existence of a highly organised market depend ? (C U)

(b) Indicate the characteristics of commodities for which there is a wide market (C U 1912) Consider the markets for cotton, fish, consols, bricks, gold (C U 1910 H)

(c) What functions in particular does a dealer or speculator play in such a market ?

29 How is the value of an article determined ? (C U 1918)

What do you understand by normal value ? Of the factors affecting the demand and the supply of a commodity, which are more important with regard to normal value and why ? (C U 1917)

Distinguish between Market Price and Normal Price, and indicate the causes which prevent ready adjustment of the one to the other (C U 1910)

30 (a) Discuss the two following propositions (a) Labour is the cause of value (b) Utility is the cause of value (C U 1909)

(b) "Value is determined by marginal utility" "Value is determined by cost of production" Discuss carefully the validity of the statements (C U 1915)

31 Critically estimate the more important of the theories of value. (C U 1913)

32 Examine the special theory of value applicable to commodities subject to (a) composite demand (b) joint supply (c) monopoly

How is the value of an article determined when the production of it is in the hands of an individual or a single corporation (C U 1917)

Money, Banking, International Trade

Money

33 Define money Explain the difficulties that beset an attempt to define money (C U 1915)

34 What are the functions of money ? (C U 1916)

35 State and comment on the economic theorem known as Gresham's Law (C U 1909)

What is Gresham's Law ? How does it work, and in what cases is it applicable ? (C U. 1917)

36 Explain Bimetallism and Monometallism, and discuss the arguments which are ordinarily urged for and against each system (C U 1910)

37 Discuss whether and under what conditions a system of bimetallic money is practicable (C U 1909 H)

38 Mention the chief causes which give rise to a movement of gold from one country to another By what means is this transfer of bullion from country to country prevented in a large degree ? (C U 1914)

39 (a) Explain and examine the Quantity Theory of Money (C U 1912 H) What would result from an increase or decrease in the quantity of money and why ? (C U 1916)

(b) Discuss the following proposition "The value of money, like the value of every thing else, is purely a question of demand and supply" (C U 1912)

(c) "That an increase in the quantity of money raises prices, and a diminution lowers them is the most elementary proposition in the theory of currency and without it we should have no key to any of the others" Mill

Examine this statement with special reference to Indian conditions and show how the theory is true only in a simple and primitive state of things (C U 1914)

40 What is the object of an index number ? How would you construct an index number of prices to show the change in prices in Calcutta during the last fifteen years ? To what points would you pay special attention ? (C U 1914)

41 Write a note on the economic effects of changes in the value of money (C U 1914).

Consider the social and economic effects of variations in the purchasing power of money (C U 1918)

42 Why is a good currency system so important to the economic prosperity of a country? (C U 1915)

Banking

43 What are the various functions performed by banks? Discuss the nature of the advantages of a good system of banking to an industrial community (C U 1911 H)

44 Explain the provisions of the Bank Charter Act of 1844 and indicate the circumstances which led to the passing of the Act Examine the arguments for and against its repeal (C U 1910)

45 Write notes on (a) the Central Bank system (C U 1913) (b) Crisis (C U 1912)

International Trade

46 "Imports and Exports of a country must be equal" Explain this (C U 1912 H)

47 Say what you know of the Mercantile System, and remark on the policy of International Trade which it gave rise to (C U 1910)

48 State the main arguments for and against Free Trade How do you account for the fact that other nations have not followed England in adopting the policy of Free Trade? (C U 1910 H)

49 What is the theory of protection? Discuss the arguments economic as well as non-economic usually urged in favour of a protectionist policy in our day (C U 1912)

What are the principal considerations which are put forward by protectionists in support of this doctrine? (C U 1917)

50 Explain clearly how international values are determined? (C U 1909)

Distribution

51 (a) "The theory of payment made for any one agent in production is in essentials the same as the theory of payment made for any other agent in production" (C U 1913 H)

(b) "The national dividend is a continuous stream from which all the factors of production are rewarded" Examine this statement and mention in particular how the owners of land are rewarded (C U (1911)

52 (a) What is meant by saying that wages tend to equal the marginal product of labour? Can you explain interest and profits in a similar way? Does such an explanation furnish any complete ethical justification of the present economic order? (C U 1913)

(b) Explain "The rate of wages is determined by the marginal productivity of labour" (C U 1917)

53 (a) Explain and examine the Ricardian theory of rent (C U 1912, 1910)

(b) Give after Marshall the modern re-statement of the theory of rent. Consider the different economic uses to which land is put in order of their intensity (C U 1918)

54 (a) Discuss (i) Rent is not an element in the price of agricultural produce (ii) Profits do not form a part of the price of manufactured products (C U 1919)

(b) How is Rent related to Price? (C U 1912 H)

55 Write a note on Quasi Rent (C U 1914)

Explain Quasi Rent and discuss the relation between Quasi Rent and True Rent (C U 1912H)

56 Discuss the effect upon agricultural rents (a) of agricultural improvements (b) improvements in means of communications (c) of opening up of a new source of agricultural products (C U 1910)

57 Contrast the advantages of peasant proprietorship and large scale farming (C U 1915 H)

58 Remark on the characteristic merits of peasant proprietorship Would you advocate the compulsory introduction of such a system in England? Give reasons for your answer (C U 1909)

59 Give some account of the Wages Fund Theory and of the controversies associated with it (C U 1911)

60 Expound the residual claimant theory of wages as put forth by Walker, and summarise Gide's comments on the theory (C U 1909)

61 Wages have been described "as the discounted product of industry" Bring out the meaning of the phrase and consider whether it is a correct explanation (C U 1915) (a) Parents have a heavy responsibility regarding the choice of occupations by their sons What evils would result if the parents were led away by mere sentiment or prejudice and did not enquire properly into the prospects? (C U 1918)

62 (b) Sketch briefly the causes of the differences of wages in different occupations (C U 1915 H, 1916) Why are some of the most unpleasant kinds of labour paid extremely low wages? (C U 1916)

(c) How would you account for the low wages paid to women? (C U 1915) Why are the wages of women low compared with the wages of men for the same kinds of work or for work requiring the same exertion? (C U 1918) In estimating the relative prosperity of the worker in different countries, is it sufficient to compare money wages? (C U 1914)

64 (a) Trace the origin of Trade Unions Explain the nature of any change which may be noticeable in the aims and objects of Trade Unions in recent years (C U 1910)

What are Trade Unions? Give their functions and indicate the methods which they adopt to raise wages (C U 1910 H)

(b) Carefully consider whether labour can raise the level of normal real wages by means of combination (C U 1915) When can wages be raised in a trade by an artificial restriction of the labour supply? (C U 1912 H

65 Examine the economic influence of strikes with special reference to their effect on wages (C U 1912)

66 Consider some of the more important plans to secure settlement of differences between capital and labour (C U 1913)

67 State the arguments for and against factory legislation (C U 1911)

68 Discuss the more important causes of unemployment in the modern industrial world, and examine the efficacy of the remedies usually suggested for it

69 Trace the development of the present system of Poor Law Administration in England What were the principles established by the Elizabethan Act of 1601, and how far have these been adhered to or departed from in modern times (C U 1909)

70 (a) Bring out clearly the difference between Rent and Interest Distinguish between Interest and Profit (b) What is the probable effect upon the general rate of interest of an increase in the volume of currency? (C U 1915)

71 (a) Discuss the nature of profits Are profits 'legalized robbery'? What is the economic justification of profits? (C U 1917)

(b) Explain and criticise the view that profits do not form any part of the price of manufactured products and do not cause any real diminution in the wages of labour (C U 1909 H)

Public Finance Economic Functions of Governments Socialism etc

72 Consider the various principles of attaining justice in taxation How far is progression in taxation possible and how would you justify it? (C U 1913)

73 What do you understand by equality of taxation? Give the general arguments for and against progressive taxation (C U 1914.)

74. Upon what principles should a Government determine its tax system? What are the advantages and disadvantages of an income tax? (C U, 1915)

75 A finance minister has to raise a certain revenue by taxing commodities What are the general principles which should guide him in selecting commodities for this purpose? (C U 1911)

76 Is there any essential distinction between direct and indirect taxes? Discuss the arguments for and against each system of taxation (C U 1910)

77 What does Walker consider to be the ideal tax, and what is meant by the purely economic theory of taxation? (C U 1909)

78 Explain what is meant by incidence of taxation Discuss the incidence of (a) tax on rent proper (b) a heavy income tax (c) a ten per cent ad valorem import duty on cotton goods in India (C U 1909 H)

Consider fully the direct and indirect effects of a duty on import of motor cars in India (C U 1916)

79 What are the considerations which should have weight with a finance minister in determining (a) the issue (b) the conversion (c) the payment of a public debt (C U 1612)

80 Discuss the arguments which are commonly advanced (a) in justification of (b) in condemnation of the present system of distribution of wealth (C U 1909)

81 Distinguish between different economic aims that have been included under the name of Socialism Briefly indicate the general argument against socialism (C U 1910 H)

82 Indicate the general drift of the criticism of the present industrial system by socialist writers and discuss the probable advantages and disadvantages of any one of the schemes advocated by contemporary socialism (C U 1910)

Criticise the following doctrine —"When giving charity, the rich are only giving back in part what they have stolen from the poor, and for this they deserve no credit" (C U 1918)

83 Consider generally the proper sphere of state action in relation to a country's industrial life (C. U 1910)

84 Comment on the following

Two of the most important discoveries made during the 19th century are (a) the immense advantages of abolishing restrictions on trade (b) the absolute necessity of imposing restrictions on labour (C U 1912 H)

85 State the arguments for and against the state working of railways (C U. 1915H.)

Miscellaneous

86 Write notes on (a) policy of making work and its evils (b) expenditure versus investment as helps to industry (c) Malthus's doctrine of population (d) Fiduciary Money Standard Money, Bank Money (e) Gold-Exchange Standard (f) The Central Bank (g) Favourable Rate of Exchange (h) Specie points (i) Crisis (j) Balance of Trade (k) Quasi-Rent, (l) Profit-sharing (m) Progressive Taxation (n) Standard of Life and Standard of Comfort

Honours questions are marked with H